Regulation

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Corporate Takeovers
Who Wins; Who Loses; Who Should Regulate?

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The Japanese Automobile Cartel
Made in the USA

BARRY R. CHISWICK

Legal Aliens
Toward a Positive Immigration Policy

PAUL H. RUBIN, R. DENNIS MURPHY, GREGG JARRELL

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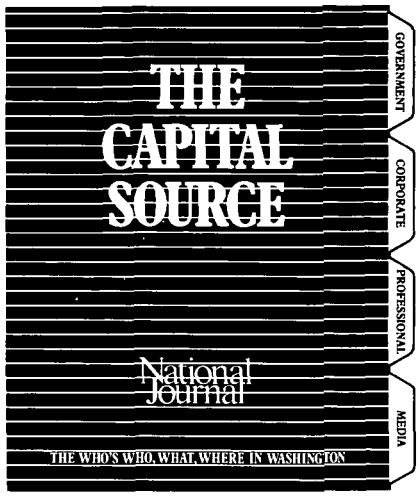

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Letters

We welcome letters from readers, particularly commentaries that reflect upon or take issue with material we have published. The writer's name, affiliation, address, and telephone number should be included. Because of space limitations, letters are subject to abridgment.

The Minimum Wage

TO THE EDITOR:

"The Minimal Case for the Minimum Wage" (*Regulation*, 1987 Number 3/4) exposes the weaknesses in arguments for raising the minimum wage. Unfortunately the minimum-wage hike contained in the Fair Labor Standards Act (H.R. 1834) will likely pass Congress under election-year pressure from organized labor. This is bad news not only for business, but also for the marginally skilled, poor, and young workers whom this legislation will affect the most.

According to the Congressional Budget Office, the proposed increase in the minimum wage could cause the loss of up to a half-million jobs nationwide. That job loss would be most keenly felt among groups in the labor force with the lowest wages—and especially among young people. The U.S. Department of Labor says that 60 percent of all minimum wage earners are between the ages of 16 and 24.

Most of these are not working poor people struggling to feed a family, but young people trying to get entry-level job experience. Fewer than 14 percent of minimum wage earners are heads of households trying to support families. Ironically the poor will be hit the hardest by the increased inflation that is sure to follow a major hike in the minimum wage.

Perhaps the threat of inflation is the single most potent argument against raising the minimum wage. Government mandates of this type, which add nothing to private-sector productivity, are the root cause of inflation and recession. The Congressional Budget Office estimates that the annual inflation rate would jump by about 0.3 percentage points under the current minimum wage proposal. That's bad news for everybody.

Labor markets should determine wages, not election-year politics. But until the leadership of Congress pays heed to the economic arguments against government mandates on business—especially the profound case against an increase in the minimum wage—we are bound to repeat the mistakes that have plagued our prosperity in the past.

Andy Ireland
U.S. Representative
10th District, Florida

TO THE EDITOR:

Many of the conclusions of the Burkhauser and Finegan study of income trends among low-wage workers ("The Minimal Case for the Minimum Wage") have been verified by other recent studies. They all dispel the common misperception that increasing the federal minimum wage will help the working poor. But these studies, as well as the recent "phantom" Congressional Budget Office report on the impact of a minimum wage increase on employment and inflation, have not deterred Congress's desire to enact such an increase. In my view, a more effective approach would be to refocus the debate toward state autonomy in setting minimum wage rates.

Last year 15 states and the District of Columbia raised their minimum wages, and another 17 states are considering legislation this year. Some of the increases are relatively small, others relatively large (although none as large as the increase to $5.05 an hour proposed in the Kennedy-Hawkins legislation). In either case, the state minimum wage increases reflect the distinct dynamics of the nation's regional economic markets and work force.

For example, California and Connecticut, which have unemployment rates of 5.6 percent and 3.8 percent respectively, set their minimum wage rates at $4.25 an hour. Only the District of Columbia has a higher minimum wage. Conversely, Louisiana, with a 12 percent unemployment rate, does not

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have a minimum wage law.

Clearly a substantial increase in the federal minimum wage would have a greater adverse impact on those states with weak labor markets or strong service-oriented economies. This was made evident by the 1988 study by Richard B. McKenzie, sponsored by the National Chamber Foundation. It concluded that "the South will be the region with the greatest job loss, approximately one-third of the total employment loss."

States should be given the flexibility to tailor their minimum wage laws to meet the diverse characteristics of their local economic markets. An additional increase in the federal minimum wage will obviously distort those markets. But focusing attention on the "nationwide" impact only dilutes the magnitude of those distortions.

David Dreier
U.S. Representative
33rd District, California

The Twisted Pair

TO THE EDITOR:

Roger Noll's prescription for increased competition in local telephone service ("The Twisted Pair," *Regulation*, 1987 Number 3/4) is a welcome beam of wisdom at a time when our entire government, except the beleaguered Judge Greene, seems to share the fantasy that local telephone monopolies transcend all known economics and can be allowed to enter new markets at will, with no danger that they will exploit captive customers and bottleneck facilities.

My only criticism is that Noll looks to further technological progress—such as radio telephone and cable television becoming cost competitive with the copper wire telephone network—as the basis for increased competition in local service. I think we should look to the past, since regulatory reforms typically lag behind the technological changes that make the existing regime untenable. Historically, the cost structure of telephone networks has shifted toward smaller portions for transmission, and larger portions for switching. Local transmission remains as much a natural monopoly as it ever was, pending the technological progress Noll predicts. But local switching seems to have evolved into a fit arena for competition.

By "local switching" I mean the functions of completing calls within the local network, interconnecting with long-distance companies for calls outside the local network, and a host of enhanced services such as call forwarding and abbreviated dialing. Sophisticated computerized switchboards (PBXs) in large business telephone systems already perform these functions in competition with local telephone companies, but the existing regulatory regime and its resulting pricing structure inhibit this competition and prevent anyone but the local telephone monopolies from offering local switching to the general public.

Competition in local switching would not require any technological advances. At present, when a subscriber's telephone line enters the local monopoly's office, it connects to a "class 5" switch, which performs local switching. Under competition, a subscriber line entering the local monopoly's office would be wired to a "cross connect," a simpler device than a class 5 switch. The cross connect would permanently (but changeably) route each subscriber's line to the competitive switching provider he had chosen. Each competitive provider's own class 5 switch could be located at the local monopoly's office, or at a remote location. Experience with the cellular radio telephone has already solved problems of numbering systems and interconnection when multiple switching systems serve a geographic area.

Thus competition in local telephone service, for which Noll so clearly shows the need, does not have to wait for the cost of alternative transmission technologies to drop to the level of the copper wire network. It waits only for regulators to make "open network architecture" a reality by allowing competition in local switching, and by requiring local telephone monopolies to offer the competitors interconnection that is nondiscriminatory in price and technical quality.

David S. Reed
Consultant
Washington, DC

TO THE EDITOR:

"The Twisted Pair" lays out succinctly—perhaps too succinctly—the choices this nation faces with regard to telecommunications. Stated baldly, the article makes it clear that the future holds a return to integrated, but regulated, monopoly unless the monopoly bottleneck of local exchange can be opened by new technology. The possibilities for new technology to achieve this end lie mostly in developing new spectrum-based technologies that do not need an unbroken physical path. But the article is too succinct in describing the difficulties of achieving this end.

It is widely believed that the relatively recent "competitive era" in interstate telecommunications was forced by new technology. This view implies that the same could occur at the local level as well. Future historians of the events of the 1970s and 1980s, however, are likely to point out that it took both new technology and a more receptive regulatory climate for the market to be opened to new technology and competitive entry. Professor Noll passes by too quickly the enormous regulatory hurdles that await new local exchange technologies. These lie mostly at the federal level, despite its public procompetitive posture.

The article describes the behavior of the FCC as procompetitive and deregulatory toward the interstate arena, and accommodating towards the state regulators. This is one explanation of why the FCC has pushed competitive and somewhat deregulatory policies for things like terminal equipment and interstate toll services, while not using its spectrum allocation policies to aid in the development of a more competitive local exchange arena. An alternative hypothesis, however, is that regulators, including those at the FCC, have a very hard time disentangling technical claims about new technologies. As a result, local exchange companies—who have had the research facilities with the greatest reputation—have consistently persuaded the FCC to make spectrum allocations in ways that in fact ensure that the new services created cannot challenge the monopoly of the twisted wire pair. This is most clearly evident with cellular radio, where the technical speci-

(Continued on page 52)

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Currents

Environmental User Fees

While *Regulation* predicted years ago that the growing budget deficit would cause agencies to find creative ways of substituting regulatory mandates for budget expenditures, we failed to predict that regulation itself would become an attractive source of revenue. In the search for "services" for which the government might charge a fee, the Office of Management and Budget and several regulatory agencies, most notably the Environmental Protection Agency (EPA) and the Food and Drug Administration, have decided that reviewing new products for safety is a service to the applicant. The Administration has proposed collecting large "user fees" from anyone seeking approval for a new drug, pesticide, or other chemical. It is requesting authority to put the revenues from these fees into special funds not subject to the appropriations process.

This proposal is ill-conceived whether evaluated on grounds of good regulatory policy or sound public finance. Moreover, it is a particularly unpromising source of revenues.

User fees are attractive in concept. When applied correctly, they enhance economic efficiency and at the same time raise revenues. Few federal taxes have both of these virtues. User fees also appear to have particular advantages in environmental management. The EPA is in the business of rationing things that are scarce—like clean air, clean water, and waste disposal sites—and user fees, or prices, are the best method we know of for rationing scarce resources.

Since the day the EPA opened for business, economists have been urging it to avoid rigid standards and to experiment with Pigovian-style pollution taxes (or their near-equivalent, marketable permits sold at auction). These user fees are scaled to extract from each polluter a charge proportional to the damage done, in an attempt to internalize the costs of pollution and to allow the market, with all its rich incentives, to find the most efficient way of improving the environment. Pollution taxes of this type could simultaneously satisfy the goals of regulatory reformers, environmental protectors, and budget balancers.

Yet pollution taxes have little hope of becoming a reality. Congress is not likely to impose them for compelling political reasons, and the EPA lacks the authority to experiment on its own. Besides, the EPA has been distracted from pursuing pollution taxes by two lesser ideas: "economic" noncompliance fees, and administrative user fees.

The first of these ideas preoccupied the EPA during the Carter Administration. Its development is credited to then-Administrator Douglas Costle and his Assistant Administrator for Policy and Management, William Drayton, who first employed economic noncompliance fees at the state environmental agency in Connecticut.

The Drayton-style noncompliance fee is an enforcement penalty. Ordinarily fines for violating a standard are spelled out in a statute. For example, the law may provide for a fine of up to $10,000 per day of violation which, below that limit, can be scaled to the "seriousness" of the violation.

But often judges or juries diminish the amount of a fine in sympathy for the company or for its employees, especially when the company appears to be at risk of failure if the full fine is assessed. In Connecticut, Drayton and Costle found that some of the major air polluters in the state continued to violate emissions standards because the state agency could not persuade a court to impose a fine large enough to make compliance a more attractive option for the companies than continued noncompliance.

The Drayton initiative is designed to remedy this problem. Whenever a company is found to be emitting a pollutant in excess of the applicable standard, a penalty is imposed that includes two components. One component is equal to the excess profit that the company earned by avoiding compliance with the regulation; the other is a punitive component designed to tip the scales in favor of compliance.

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The EPA has sophisticated financial models to calculate exactly what a company's excess profit is. In effect, this component of the fine takes back from a polluter his "ill-gotten gains"; it demonstrates persuasively that crime doesn't pay, and it appeals to judges and juries as a fair penalty. The EPA has found that this type of fine is rarely reduced by a court, unless the company can show the agency's calculations to be in error. The Drayton noncompliance fee is designed by and for lawyers, and it has to be judged a success at what it set out to do. It is, all in all, a creative application of economics in the service of law enforcement.

It has little appeal for economists, however, because of one unfortunate flaw: it uses economic incentives to aggravate the worst features of command-and-control regulation, rather than to ameliorate them. It eliminates the possibility of what would be called, in contract law, "efficient breach." There are certainly occasions that arise when the cost of complying with a regulation soars to impossible heights and the public benefit from compliance drops to trivial levels. But instead of tolerating an optimum amount of noncompliance, the Drayton initiative ensures blind adherence to whatever the standard happens to be. In a system of standards that is already too rigid, it removes the last wiggle of flexibility.

The development of the EPA's policy on noncompliance fees in the late 1970s prevented the agency from exploring more efficient types of enforcement penalty. In economic terms, the agency's mistake was to focus all of its attention on figuring out the "reservation price" of the regulated companies, rather than the reservation price of the public.

It would be far more efficient for the EPA to research the damages being done to the community by noncomplying firms, rather than the profits being earned. Properly presented, a damage-based penalty would be persuasive to judges and juries. In addition, it would allow the EPA to apply its prosecutorial discretion and its authority to collect enforcement penalties as a form of user fee for the environment.

The Reagan Administration's user-fee initiative is equally wrong-headed. The EPA proposes to charge a fee for processing applications for new product approval, equal to the agency's administrative cost of reviewing the application. This focuses the burden of the user fees where they have little prospect of improving efficiency, and indeed where they are likely to do the most damage.

Our regulatory apparatus is already far too preoccupied with new technology. A disproportionate share of regulatory resources is devoted to what Peter Huber has dubbed "gatekeeping"—giving close scrutiny to any new entrants in an industry to ensure levels of safety many times stricter than what we tolerate among existing products or firms. (See "Exorcists vs. Gatekeepers in Risk Regulation," *Regulation,* November/December 1983.) Generally, new pesticides, new chemicals, and new drugs present small risks compared with older technologies—either because technology has improved, or simply because their market share is so much smaller than that of existing products.

Yet the bias against new sources of risk is pervasive. New sources are very easy targets for regulators. They can be held hostage in a way that no existing source would ever tolerate. The consequences of the bias are severe, because the misplaced regulatory focus inhibits both innovation and competition. The flaw in the Reagan Administration user-fee proposal is that it attempts to collect revenues from the very same sources that already are bearing the brunt of regulatory costs—new firms and new products.

The proposal may also create perverse incentives for the agencies, turning them from gatekeepers into toll collectors. Asking companies to pay an entry fee invites an agency to fall into the same traps that plague economic regulation: becoming a captive of the regulated industry, using licensing authorities to protect the industry from competition, and in turn relying on the industry for revenues and political support.

The real opportunity for the EPA is to charge user fees for using the environment—not for using the services of the agency. If the EPA decides to limit lead in gasoline, or acid rain, or chlorofluorocarbons, then user fees are an efficient solution. They force firms to pay for the damage done to the environment or for the scarcity value of the resources that they consume. There is no need for an entry fee—new and old alike should pay in proper proportion.

The idea that should be kept in mind in thinking about user fees at the EPA is that clean air and water are the resources that are scarce and that should be charged for. Federal bureaucrats are not particularly scarce, and should not be the focus of user fees.

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Censored Satellites

Last year, the Commerce Department issued regulations that restrict the freedom of American companies to take photographs from space. Under the regulations, the Departments of State and Defense can veto a private company's application for a license to operate satellites that produce high-resolution photographs. Furthermore, license holders are required to "operate the system in a manner consistent with national security and the international obligations" of the United States. The sanctions for violations are seizure of the "offending" equipment and fines of up to $10,000 per day.

The regulations implement a provision of the Land Remote-Sensing Commercialization Act of 1984. Ironically the main purpose of this law was to speed the private development of space by privatizing land remote-sensing satellites, Landsats, owned by the U.S. government. (The new owner and operator of the Landsat system is the Earth Observation Satellite Company, EOSAT, a joint venture of RCA and Hughes Aircraft Corporation.)

The greatest objections to the regulations are being raised by the news media. This is not surprising since high-resolution photographs from space promise to make a major contribution to journalism. News reports on the Chernobyl nuclear accident, the Soviet space-shuttle site at Tyuratam, and the Soviet radar facility near Krasnoyarsk are among those that have been bolstered by satellite photographs.

What are the journalists' objections? An attorney for the Radio and Television News Directors Association, Robert J. Aamoth, for example, argues that the regulations violate the First Amendment. The position of the RTNDA and other news organizations is that taking pictures is news gathering, which is a freedom covered by the First Amendment's protection of freedom of the press.

There is a certain logic to this argument. When a reporter covers a political speech, for instance, he is gathering news. Is the newspaper's First Amendment right to print the story protected if the reporter has no right to cover the speech? If it were, one could imagine a situation in which freedom of the press was "guaranteed"—but reporters were legally prevented from leaving their buildings or using their telephones. As the U.S. Supreme Court recognized in *Branzburg* v. *Hayes* (408 U.S. 665, 1972),"without some protection for seeking out the news, freedom of the press could be eviscerated."

Media organizations also point out that the Commerce Department's rules fail to spell out in advance all the requirements that licensees must meet, and more important, all the reasons that licenses may be revoked. Officials in the State and Defense Departments now have enormous discretion to decide whether a company's particular use of photographs has violated the terms of the license.

This pragmatic objection is crucial to evaluating the prospects for private ownership of satellites capable of producing high-resolution photographs. According to Congress's Office of Technology Assessment (OTA), a media satellite would cost $215 million to $470 million to build and launch, and another $10 million to $15 million per year to operate. Even before the regulations were issued, private investors had demonstrated their reluctance to make such investments; no private company had chosen to produce and launch a media satellite. As a result of the regulations, investors are now confronted with the risk that the government may confiscate their capital for unanticipated reasons.

U.S. military officials defend the regulations on the grounds that the press, by printing or broadcasting photographs from space, could seriously harm our national security. A photograph of a secret U.S. troop movement, for example, could compromise important U.S. military operations.

This is a legitimate concern. The question, though, is whether restricting American companies' freedom to launch satellites to take photographs from space will solve the problem. Most likely, it will not.

Two factors undermine the probable effectiveness of such restrictions. First, the right photograph taken from the ground or from an airplane can be just as harmful as one taken from space. No licenses are required to take such photographs today.

Second and more important, nothing in the regulations prevents the U.S. media from buying high-resolution photographs taken by the satellites of other countries. Indeed, some of the most striking photographs used in news reports to date have been taken by the French government's SPOT satellite and sold through a private French company to the American media. And

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ironically, only three days after the Commerce Department issued its regulations, the Soviet Union announced plans to sell photographs to the media. The Soviet photographs have a resolution as high as six meters (that is, the photographs can reveal objects measuring six-by-six meters on earth), as compared to 10 meters for SPOT and only 30 meters for Landsat. That there are competing sources of supply of satellite photographs—even in countries with competing forms of government—minimizes the harm to U.S. security that can be done by privately owned American satellites.

Moreover, a case can be made on national security grounds *against* restricting satellite photography. A look at the Western media's use of satellite photographs to date is instructive. Of 16 major uses of satellite photos listed in a 1987 study by the OTA, 15 were of closed (that is, unfree) societies. Of the 15, 10 were of the Soviet Union—8 of these were of military sites and 2 were of Chernobyl—2 were of the Iran-Iraq war, 2 were of Libya's military, and 1 was of Pakistan's controversial nuclear processing facility. Just 1 was of New York City's harbor.

This is no accident. Not much happens in the West that photographers are not allowed to photograph using more conventional means. We simply do not have much to hide. Not so for the Soviet Union or other closed societies. Photographs from space narrow the information gap between closed and open societies. Allowing unrestricted use of pictures from private American satellites would reduce the gap even further.

This leveling of the information is useful because it makes the Soviet Union and other closed societies less able to hide an event such as the Chernobyl disaster. It also constrains our government to be more honest with us about what the closed societies are up to: the American Broadcasting Company's photographs of the Soviet phased-array radar facility at Krasnoyarsk—thought to violate the SALT II treaty—are a case in point. Certainly using private American satellites seems preferable to relying exclusively on Soviet and French government satellites.

A novel case for restricting the press's access to satellite photographs was given by Dino Brugioni in a 1986 *Washington Post* article. Brugioni, a former photo interpreter for the Central Intelligence Agency, argued that aerial photography and multisensory imagery are too important as "sources of information and credibility for the analysis to be left to amateurs." In short, the media might misinterpret photographs. But members of the media regularly misinterpret all kinds of data, including some very important economic data. Does anyone seriously argue that we should restrict their access to basic information about the economy?

President Reagan introduced a new wrinkle in the debate over licenses on February 11, 1988, when he announced his "Commercial Space Initiative." Point 7 of this 15-point program covers remote sensing:

> The Administration is encouraging the development of commercial remote sensing systems. As part of this effort, the Department of Commerce, in consultation with other agencies, is examining potential opportunities for future Federal procurement of remote sensing data from the U.S. commercial sector.

A related National Security Decision Directive the President signed on January 5 also calls for the encouragement of U.S. commercial remote sensing systems that are "superior to foreign-operated civil or commercial systems." Presumably "superior" refers to, among other things, the resolution the systems are capable of.

It is unclear what effect these recent pronouncements from the White House will have on the Commerce Department's regulations. Regardless of the fate of the regulations, the U.S. media will broadcast and publish photographs from space. The question that remains is which country's satellites will supply them.

For Want of a Wheel

On March 14, 1988, the Consumer Product Safety Commission (CPSC) and the five U.S. distributors of all-terrain vehicles reached a controversial legal settlement that, among many other things, prohibited all future sales of three-wheeled ATVs. Four-wheeled ATVs are still available, but may be sold only to certain age groups, and must be accompanied by warnings and an offer of free safety training. The settlement ended a lawsuit in which the CPSC sought to order a mandatory recall and refund program for all three-wheeled ATVs already sold, as well as for any four-wheeled machines that had been sold for use by youngsters. It was controversial mainly because several interveners in the lawsuit

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argued forcefully (in the press and in Congress, as well as in court) that the CPSC should refuse to drop its demand for a recall.

To obtain a recall, the CPSC needed to prove to the court that the ATVs were not merely defective, but "imminently hazardous." In various analyses, the commission argued that three-wheeled ATVs were more hazardous than similar vehicles possessing one more wheel (four-wheeled ATVs), one less wheel (dirt bikes), and no wheels at all (snowmobiles). On the basis of the evidence compiled, the most that an unbiased observer might confidently conclude is that all of these vehicles are associated with a certain amount of risk and that, until someone markets a motorized unicycle, none of them stands out as uniquely hazardous.

The regulatory struggle over ATVs began four years ago, in March 1984, when the CPSC staff began investigating the cause of the rising number of injuries and deaths associated with ATVs. In 1985 the commission published a seven-step action plan in the *Federal Register*, followed by an advance notice of proposed rulemaking. At this point the CPSC appeared mainly to be interested in working out some voluntary safety measures with ATV distributors. One commissioner would not even concur with the CPSC's preliminary finding that there "may be an unreasonable risk" associated with ATVs; two commissioners (of four then sitting) testified that there was no basis in the record to justify any mandatory action. The CPSC staff continued to work with the industry on voluntary measures to reduce risks.

But by this time, ATV accidents were making the evening news, and the public was reaching its own conclusions. In May 1985, a House subcommittee held hearings and voted to recommend a ban on some types of ATVs. Though not binding on the commission, the subcommittee vote increased the public pressure for action.

The CPSC created a special internal task force to evaluate the evidence, and received its recommendations on September 30, 1986. The task force recommended a range of actions, but found no imminent hazard, and recommended no ban, recall, or refund program for three-wheeled ATVs. Nevertheless, 10 weeks later the commission decided (in a two to one vote) to ask the Justice Department to bring a suit under Section 12 of the Consumer Product Safety Act. Section 12 is an emergency provision allowing the commission to seek relief directly in federal district court, bypassing rulemaking, adjudication, and any other administrative steps that ordinarily accompany a regulatory action.

The government's complaint requested an injunction halting sales of three-wheeled ATVs and requiring the repurchase of those held by dealers, a recall and refund for all three-wheeled ATVs and for all adult-sized four-wheeled ATVs used by children under 16 years, and age restrictions for the various ATV models. In addition, it requested a free, hands-on training course "to teach adequately the skills and knowledge necessary to ride an ATV safely," an effective public awareness campaign, labels on new models and

> The United States of America . . . brings this action for declaratory and injunctive relief to protect the public from the imminent and unreasonable risk of death and severe personal injury presented by motorized vehicles known as "all-terrain vehicles," or "ATVs."
>
> Each day millions of individuals, a large number of them children under the age of 16, are unwittingly exposed to the risk that, as a result of their operation of ATVs, they will be involved in an accident in which they will either die or suffer a severe personal injury such as quadriplegia, paraplegia, a ruptured organ, or a skull or bone fracture.
>
> Far from being safe, easy-to-ride vehicles for harmless play, as defendants have falsely and deceptively represented them to be, ATVs actually are unique and complex vehicles, requiring for their successful operation constant and precise rider manipulation which is neither instinctive nor easily mastered by a person of ordinary skill. Moreover, in contrast to the operation of other motor vehicles and unbeknownst to ATV riders, there is virtually no margin for error in the operation of ATVs because of their peculiar operating characteristics, and the penalty for making the smallest miscalculation may be death or a severe injury.
>
> The precautions necessary to abate the grave hazard posed by ATVs . . . are relatively inexpensive, particularly when compared to the high cost in human suffering caused by ATVs. Nevertheless, the manufacturers and distributors of ATVs have failed to implement these precautions.
>
> The United States brings this action to gain the immediate relief necessary to protect the public from the unreasonable and imminent peril in which the defendants have placed, and continue to place, the millions of innocent, inadequately informed individuals who presently operate, or will in the future operate, ATVs.
>
> Complaint, *United States of America* v. *American Honda Motor Company, Inc.*, et al.

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"The trouble is — it doesn't seem to have any defects. I was looking for something with more liability potential."

made available for models already sold stressing "the complexities and hazards associated with ATV riding," and a toll-free ATV-safety hotline. The defendants were the five distributors of ATVs in the United States: American Honda Company, Yamaha Motor Corporation, U.S. Suzuki Motor Corporation, Kawasaki Motor Corporation, and Polaris Industries. The Japanese manufacturers of ATVs were also named.

The complaint clearly abandoned the CPSC's cooperative approach of working with the distributors, and strongly argued the case for mandatory action. The essence of the complaint, which is reproduced in part in the box on the previous page, was that the risk of serious injury or death was unreasonably high, that the skill required to avoid injury was unreasonably great, and that manufacturers and distributors had failed to implement steps to reduce risks, despite the relatively low costs of doing so.

A benefit-cost estimate by the CPSC staff supported some of the information-providing remedies sought in the complaint. Indeed, these were the sort of actions for which the staff had been negotiating with the distributors. And by this time, the proposed ban on future sales of three-wheeled ATVs would simply ratify a judgment the marketplace appeared to have made already: sales had shifted from more than 80 percent three-wheeled ATVs in the early 1980s to more than 80 percent four-wheeled ATVs. The provision that terrified the distributors was the requirement that they offer refunds for the roughly two million three-wheeled ATVs already sold.

The CPSC based its case primarily on data compiled through its National Electronic Injury Surveillance System, which tabulates product-associated injuries from approximately 65 hospital emergency rooms across the United States. After analyzing the NEISS data over the period 1981 to 1986, the CPSC staff concluded that ATV-related injuries were increasing at an annual rate of over 60 percent, that ATVs were unusually hazardous compared to dirt bikes and snowmobiles, and that three-wheeled ATVs were especially hazardous because they were more unstable than four-wheeled ATVs.

Despite strongly conflicting views on the safety of ATVs, the government and the manufacturers signed a preliminary consent agreement in December 1987, and a final settlement shortly thereafter. The terms of the final consent decree included most of the measures that the government had requested, including a halt in the sale

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of three-wheeled models. But the agreement provided for no recalls, refunds, or exchanges.

Why did the government settle the case without a mandatory recall and refund program? The official reason is that the settlement saved the public the cost of litigation, and it obtained most of the remedies the government was seeking, without the years of delay that litigation would entail. There have been allegations that the settlement was politically motivated, just as there were allegations that the bringing of the suit in the first place was politically motivated. Yet another possibility is that the government simply could not prove its case.

The data base used by the CPSC is fraught with problems. The NEISS sample of injuries is small, biased in a variety of ways, and tainted with misreporting. In their rebuttal risk-analysis, the ATV distributors argued that the sample used to evaluate ATVs included only 288 injuries (of an alleged universe of 300,000); that it was concentrated in the Northeast, and did not adequately represent the different terrains and riding conditions of the West and South; that it evaluated injuries only in the spring and summer, excluding injuries from fall or winter terrains; and that it failed to include injuries that resulted in death or that bypassed emergency rooms. They also investigated the NEISS data base and found extensive coding errors, typically the misclassification of the type of vehicle involved or the cause of the accident.

The CPSC's raw data on injuries showed a 70 percent annual growth rate in ATV-related injuries during the sample period—certainly an alarming trend. But after correcting for identifiable coding errors, the injury growth rate dropped to 46 percent annually. After correcting for the growth in the number of vehicles in use, it dropped to 11 percent, which was not statistically different from zero. Of course, an 11 percent annual growth rate in the per-vehicle injury rate might still be worrisome if it were accurate and likely to persist. But the distributors argued it was not. They pointed out that the injury rate associated with ATVs was following the same kind of time-profile as injuries associated with snowmobiles or with dirt bikes when those products were new. Each of them displayed a high injury rate in the early years, dropping off to a lower level as the market matured.

This "experience curve" effect can be attributed to any number of factors: the experience of the manufacturers in producing safe vehicles, the experience of the riders, the emergence of riders' clubs, or the development of special trails and riding areas that are relatively safe. In any event, the time trends in ATV injuries appeared routine. Moreover, the injury rate per hour of ATV use did not appear different from the rate for other vehicles: 0.120 per thousand hours of use, compared to 0.116 for mini/trail bikes and 0.115 for snowmobiles.

The distributors acknowledged that three-wheeled ATVs were disproportionately represented in the CPSC injury sample: 82 percent of ATVs have three wheels, and these were associated with 86 percent of the injuries in the sample. The CPSC attributed this to an inherent instability in the three-wheel design. But the distributors pointed out that the higher injury rate was not significant and was observed only for relatively minor injuries; the rate of serious injury or death was the same for three- and four-wheeled ATVs. ("Imminent hazard" is defined by the statute only in terms of serious injury and death.) Moreover, the conclusion that instability was a contributing factor relied on a statistical analysis that included accidents in which the ATVs tipped or overturned—whether or not the rider's injury was caused by the tip or overturn. For example, a rider might run into a car, injuring himself and also causing the ATV to overturn. Injuries that actually *resulted* from a tip or overturn showed the opposite bias: they accounted for 48 percent of injuries associated with three-wheeled ATVs and 52 percent of those associated with four-wheeled ATVs. Therefore, while three-wheeled ATVs appear somewhat more hazardous, this does not seem to be related to instability. It could simply be because three-wheeled vehicles are disproportionately ridden by young riders (16 to 24 years old), or because they are disproportionately used for stunt riding and racing. Substituting four-wheeled vehicles for three-wheeled vehicles among these riders and for these uses may have very little effect on the injury rate.

None of this will bring back the three-wheeled ATV. The "imminent hazard" label has stuck, and if the settlement agreement or shifting consumer choices had not taken them off the market, undoubtedly product liability suits soon would have. The CPSC's foray against ATVs calls into question the popular notion that federal preemption of state product liability laws will make those laws substantially more rational and predictable.

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The Japanese Automobile Cartel Made in the USA

Arthur T. Denzau

IN MAY OF 1981, at the urging of the U.S. government, the Japanese government organized a cartel for the export of motor vehicles to the United States. The government of Japan imposed a voluntary export restraint (VER) on its auto makers, administered by the Ministry for International Trade and Industry (MITI). Over the past seven years, the VER has extracted billions of dollars of tribute from American car-buyers to the benefit of Japanese auto workers and the stockholders of Japanese auto makers.

Coming in the wake of the oil price hikes of 1979 and record losses in 1980 by U.S. auto makers, the VER was intended to halt the growth of Japan's share of U.S. car sales, and to provide the United States time to catch up with the Japanese in producing smaller, more fuel-efficient cars. Japanese manufacturers, it was said, viewed the VER as a violation of free trade. They spoke of it critically and suggested that their government had forced it upon them in order to undercut attempts by American protectionist interests to get still more onerous trade restraints.

According to my research, the idea that the Japanese would be hurt by the VER was fundamentally wrong. The VER promised large benefits to the stockholders of auto makers in Japan, and Japanese investors were well aware of this when the VER was imposed. Rather than improving our competitive edge, the VER has encouraged the Japanese to begin producing larger, more expensive cars, thus making them an even greater competitive threat for the future.

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The Genesis of the VER

When the Organization of Petroleum Exporting Countries tripled the price of a barrel of crude oil in 1979, and U.S. gasoline prices jumped to $1.40 per gallon, car buyers reacted in predictable ways. They reduced their purchases of new cars and dramatically altered their purchases toward smaller, more fuel-efficient cars. Small foreign cars, particularly imports from Japan, sold at a record rate. The Japanese share of the U.S. market, just 12 percent in 1975, jumped to 27 percent in 1980. In that year the "Big Three" U.S. auto makers lost $4 billion: Ford had a record annual loss of $1.5 billion, as did Chrysler with a loss of $1.7 billion. By the end of the year, an estimated 210,000 U.S. auto workers had been laid off, and both the United Auto Workers union and industry management were pushing for protectionist relief.

The election of Ronald Reagan in November 1980 seemed initially to be a blow to protectionist forces. But there were indications that the new Commerce Secretary, Malcolm Baldrige, would recommend a meeting with Japanese government officials to discuss voluntary limits on auto imports. Shortly thereafter, it became known that Transportation Secretary Drew Lewis was preparing a task force report that was expected to pave the way for a voluntary export

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restraint. There were also rumblings on Capitol Hill; Senators John Danforth and Lloyd Bentsen announced their intentions to introduce a bill to restrict the entry of Japanese cars.

Although Japanese spokesmen indicated that their government would not act to limit automobile exports unless specifically asked to do so, it was only a matter of weeks until MITI announced it was preparing a "compromise" plan. On April 30, 1981 the U.S. and Japanese governments announced an agreement to restrain Japanese auto exports to the United States for a three-year period. The quota for the first year was set at 1.68 million cars, which was 120,000 lower than actual imports in 1980. Further details were still to be negotiated, including how the quota would be allocated among Japanese auto firms.

In June it became public information that MITI had told each Japanese auto maker how many cars it would be allowed to sell in the United States. Each firm's assigned market share (for the 12 months ending on March 31, 1982) was proportional to its 1979 sales.

The original VER agreement expired in 1985. However, it has been voluntarily extended by the Japanese government each year since, and remains in effect today. Remarkably, there is still no clear consensus about what the effects of this policy are, or why the Japanese government chooses to continue these limits. The dominant view is that the quotas were accepted by the Japanese because they were judged to be less onerous than legislation pending in Congress. Presumably they are continued because of an ongoing concern about possible legislative action. This view needs to be analyzed further.

The Making of a Cartel

I believe the VER effectively cartelized the Japanese automobile industry by limiting the number of firms which could supply cars to the United States and by allocating export assignments to these firms. To the extent that these limits were binding, the VER prevented effective price competition among Japanese auto makers, enabling them to raise prices and increase their profits. If this is correct, the expected boost for business should have been reflected in the price of the common stock of Japanese auto makers as soon as the news about the VER became available.

A casual look at the data on stock prices suggests that Japanese investors expected the VER to have a positive effect on the automobile industry. The bar chart on the opposite page provides information on the price of the common stock of each of the six major Japanese auto makers. The dates selected are April 1, 1981, before any formal announcement about a VER; May 1, after the preliminary announcements; and July 1, after MITI announced the allocation of the quota among individual firms. As shown, between April 1 and May 1, stock prices jumped 23 percent for Nissan, 33 percent for Toyota, and 35 percent for Honda. Overall, the six firms gained an average of 24 percent, or about $1.85 billion in total value. Not all of this rise can be attributed to the first MITI announcement on April 21. Clearly something happened in April that caused investors to view the Japanese automobile industry as a much better investment at the end of April than at the beginning. Between May 1 and July 1, stock prices rose another 20 percent on average. The total rise in market value for the six firms in these three months was $3.8 billion, or 49 percent.

It would appear from these data that Japanese investors knew that the VER was a cartel that would help the auto makers. But in order to draw any solid conclusions, the data on stock prices must be more carefully analyzed.

Analyzing the 1981 VER

Finance analysts have developed an empirical technique called an event study to examine the effects of government actions on the prices of sensitive assets. The value of a firm's common stock is expected to reflect all the factors affecting the future profitability of that firm. Any change in a firm's valuation between two dates must be adjusted for changes in the market rate of return. The remaining so-called excess (or net-of-market) returns should reflect matters relating to the specific firm and its industry. Applied to the 1981 auto VER, an event study makes it possible to determine whether auto stock prices moved differently from the rest of the market around the date of each important event in the VER's creation and continuation.

To determine this I studied common stock prices for the six large Japanese auto makers receiving allocations: Daihatsu Diesel Manufacturing Company (a Toyota supplier), Fuji Car Manufacturing Company, Honda Motor Company,

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Mazda Motor Corporation, Nissan Motor Company, and Toyota Motor Corporation. These firms produced 93 percent of total Japanese auto exports to the United States in 1980, and were engaged almost exclusively in assembling motor vehicles. The event study analyzes the excess returns of these companies in the two market trading days beginning on the day the events were announced in the United States.

The key events in the creation of the VER are as follows: April 21, 1981, MITI's first announcement of a VER; April 30, the U.S. and Japanese governments' joint announcement; June 10, MITI's announcement of the quota allocations; and June 24, the announcement of a similar VER between Japan and the Federal Republic of Germany. The results of the analysis of net-of-market changes in stock prices for the April 21 announcement are illustrated in the chart below.

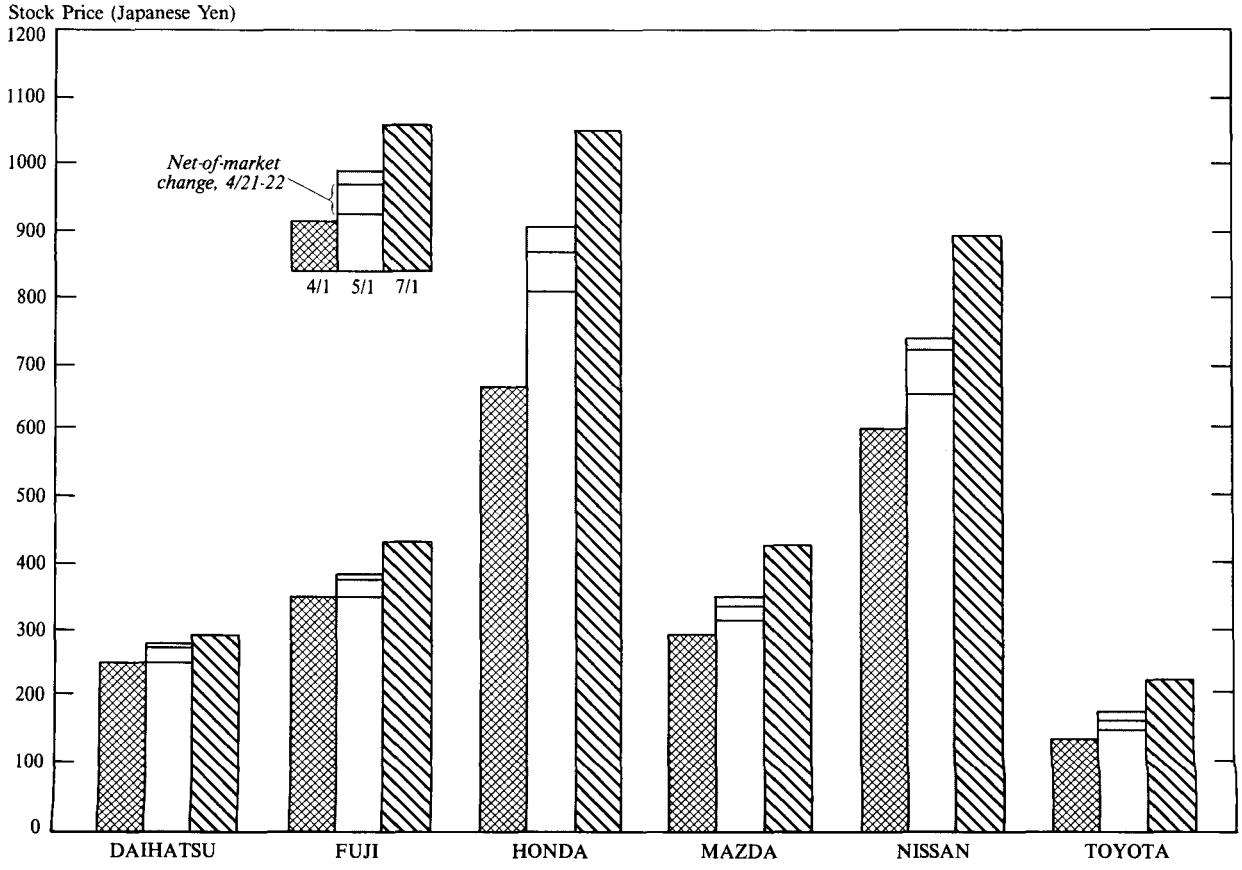
As shown in the chart, Japanese auto stock prices jumped substantially when MITI announced the imposition of the VER in April 1981. The net-of-market increase in stock prices ranged from 6.1 percent for Mazda to 14 percent for Nissan. The total stock value of the six firms rose $915 million in just two days, April 21 and 22, representing an average increase of 11.8 percent. Thus approximately half of the gains during April appeared as a prompt response to the VER announcement. Stock prices remained at the new higher price level. This large permanent increase in stock prices for Japanese auto makers suggests that the profit implications of the VER were well understood by Japanese investors.

American Auto Stocks

Given the large immediate effect of the VER on the value of Japanese auto makers, it is reasonable to ask whether shareholders of U.S. firms also benefited. The VER is a quota which, by reducing the availability of Japanese cars, should have raised the price of both Japanese and American cars and increased the number of American-made cars sold.

To determine the effect of the VER on U.S. firms, I examined common stock prices for our

JAPANESE AUTO STOCK PRICES (4/1/81-7/1/81), AND EFFECT OF VER ANNOUNCEMENTS



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five big auto makers—American Motors Corporation (AMC), Chrysler Corporation, Ford Motor Company, General Motors Corporation (GM), and Honda—in the five-year period 1981 through 1985. All except American Motors showed substantial share price increases between April 16 and 24, 1981. By May 1, however, these increases had vanished for both Chrysler and Ford.

The initial increase in stock prices is consistent with the view that the VER was a protective device aimed at improving the health of these firms and restoring employment. But why did only GM and Honda sustain the increase? A simple explanation is available. AMC and Ford were very weak and seemed headed for bankruptcy. Even if the VER promised to help the profitability of these firms eventually, an intervening bankruptcy could have wiped out the equity owners. Chrysler had already gone through a reorganization equivalent to a bankruptcy in order to qualify for a federal government bailout loan in 1979. Its finances were still fragile.

Within eight days of the announcement of the VER, these three struggling firms issued their regular quarterly earnings reports. While poor performance was probably anticipated by some investors, the losses were large enough to shake the confidence of many in the continued viability of these firms. Chrysler had lost $298 million during the first quarter, at a time when its common stock was worth only $452 million. Ford's situation was only slightly less desperate, with losses of $440 million compared to a stock valuation of $2.8 billion.

The table below shows the effect of the VER on the market value of U.S. auto firms. (Because the announcement of AMC's gloomy quarterly report coincided with the announcement of the VER, AMC was excluded from this portion of the study.) Each firm gained at least 3.8 percent in value due to the VER announcement. Overall, the stocks of these four firms rose 8.7 percent, representing a gain of $1.9 billion for shareholders. The largest gainers were Chrysler and American Honda, the two firms with the largest proportion of sales in small cars.

Apparently, from the standpoint of automobile company managers, political lobbying for a VER had been a profitable use of their time. But one must remember who paid the price. Japanese automobile manufacturers were not harmed by the VER—they gained over $900 million in value. It was the American car-buying public that had to face an artificially restricted supply of Japanese imports and at the same time pick up the tab for higher prices on all automobiles.

Reagan's About-face

On March 28, 1985, the Reagan Administration announced that the United States would not seek to have the automobile quotas extended for another year. The decision came on the heels of two good years for U.S. auto makers. With the general economic recovery in 1983, car sales in the United States rose 18 percent, and all of the gains went to U.S. firms. Sales by U.S. firms, flat in 1981 and 1982, jumped 26 percent in 1983. This was the first sign that American firms were actually gaining market share under the VER. Profits rose substantially, reaching over $6 billion, and employment rose somewhat. Profits rose again in 1984, reducing support for the VER's continuation.

The President's announcement had the expected effect on the stock values of U.S. auto firms, which is shown in the table for all five of the publicly traded firms, including AMC. All firms dropped in share price, with the portfolio dropping 2.4 percent. This drop represented a loss in share value of almost $1 billion, over half of the increase generated by the original MITI announcement in 1981.

CHANGES IN VALUE OF U.S. AUTO COMPANIES DUE TO VER ANNOUNCEMENTS*
($ amounts in millions)

U.S Auto Company	MITI Announces VER (4/21/81)		Reagan Announces Non-renewal (3/1/85)	
AMC	N/A	N/A	−$16.5	−4.1%
CHRYSLER	$47.6	10.5%	−51.1	−1.2
FORD	106.5	3.8	−149.8	−1.9
GM	1,448.0	9.1	−598.5	−2.4
HONDA	277.5	12.0	−182.6	−3.6
ALL COMPANIES	$1,879.7	8.8%	−$998.5	−2.4%

*Value of outstanding common stock based on net-of-market changes in stock prices during April 20-24, 1981, and March 1-2, 1985.

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The Japanese Response

Unfortunately for American car-buyers, the VER was voluntarily extended by the Japanese government in 1985 and continued each year since. This government action protects the auto cartel from the antitrust objections it would otherwise be subject to in U.S. courts. The quotas were set at 1.85 million for the fifth year (same as the fourth year) and 2.3 million for the sixth and seventh years.

Apart from enjoying the higher profits on their small exported cars, the Japanese have also been moving into new markets, causing new problems for U.S. auto makers. Under the VER, the Japanese have shifted from the economy end of the automobile market to luxury compacts and sports cars. Between 1980 and 1984 alone, large and sporty models increased from 45 percent of Japanese exports to 57 percent. This shift is consistent with the finding of economist Rodney Falvey that any quantitative limitation on imports, such as a quota or VER, can be expected to result in exporters shifting to higher priced, higher quality units. Removing the VER today would find Japanese imports competing almost across the board with Detroit's products, a situation that stands in marked contrast to that of the 1970s.

Japanese profits have risen dramatically under the VER. For example, excluding its American sales corporation, the after-tax profits of Honda rose from 30 billion yen to 44 billion yen between the year ending February 1981 and the year ending February 1986. Profits in the Japanese domestic market, by contrast, have been poor; one analyst has concluded that even though less than 20 percent of Japanese production is shipped to the United States, these sales are responsible for over 75 percent of profits.

Prices of Japanese cars sold in the United States also have risen substantially (and the rise began even before the rise in the yen). Robert Feenstra of Columbia University estimates the per-vehicle price increase at $1,100 between 1980 and 1984 while Robert Crandall of the Brookings Institution estimates a $940 increase between 1981 and 1982. Instead of being guilty of dumping, as U.S. manufacturers sometimes complain, the Japanese actually charge lower

"Why do I get the feeling that as soon as we perfect the compact car, the Japanese will come out with a large car?"

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prices for automobiles in the domestic market than in the U.S. market.

This information on price increases, coupled with published estimates of the responsiveness of foreign car sales to price, can be used to estimate the quantitative effect of the VER. I estimate that absent the VER, 2.365 million Japanese cars would have been sold in the United States between April 1, 1984 and April 1, 1985, as compared to the quota of 1.92 million cars. Thus the net effect of the quota in that year was 445,000 fewer Japanese cars sold in the United States. As Japanese auto sales in the United States have slacked off in the last year, the effect of the VER on imports has been diminishing.

Removing the VER

What would occur if the VER were removed? At this point, the removal of the VER would have a rather small effect on total imports. The reason is that for the first time since 1981, Japanese car sales in the United States have actually fallen somewhat, down 5 percent in 1987; recent price increases due to the yen revaluation should continue this decline. Most Japanese auto makers sold fewer vehicles than permitted under their quota limits last year, and for these companies, removing the quotas would have no effect on price and sales. However, several firms (including Daihatsu, Toyota, and Honda) could easily sell more cars in the United States. In these cases the quotas are restricting the availability of cars and raising their prices.

While removal of the VER would have a relatively limited effect on total imports, it nevertheless would accomplish two goals. First, it would eliminate the excessive profits earned by Japanese and American companies under the VER, and management could devote more of its attention to competitive strategy and less to lobbying. Second, it would eliminate the distortion of relative prices and the resulting interference with consumer preferences.

Voluntary vs. Mandatory Trade Rules

A VER has been viewed by many economists and free-trade oriented politicians as superior to legislative remedies. The rationale is that legislation is inherently inflexible because it can only be removed by new legislation. This difficulty is exacerbated by the decentralization of decision-making power within Congress: committees make the key decisions. Unless the committees with jurisdiction in both houses of Congress want to change a law protecting the auto industry, the law is not likely to get changed. Fears about the difficulty of marshaling the necessary forces to get a bill through Congress makes these analysts favor an administrative remedy, such as a VER.

The history of the auto VER suggests that these concerns may be misplaced. Certainly the VER leaves discretion in the hands of the President, not Congress, but it creates a foreign pro-protection interest group over which we have no direct control. Japanese auto makers can lobby their government to extend their cartel voluntarily while labeling the policy "sensitivity to the needs of American workers and firms." Getting rid of the cartel cannot be accomplished by administrative action by the President. It cannot be removed by congressional action. It is far from obvious why it is better to leave our economic policy in the hands of a foreign government than in the hands of Congress.

Trade restrictions such as the VER are ultimately ineffective in enabling domestic industry to prepare itself better for foreign competition.

Conclusions

Trade restrictions such as the VER are ultimately ineffective in enabling domestic industry to prepare itself better for foreign competition. The foreign competition never sits still. Further, such restrictions relieve domestic firms and labor unions from the greatest impetus for making the difficult choices necessary to adapt to changing market conditions—the push of free competition and its substantial rewards and penalties. Circumstances now favor American firms competing with the Japanese. If American car-buyers are ever going to be allowed to make free choices among competitively priced Japanese and American cars, this is the time to remove the protective barrier. Absent compelling foreign policy reasons to the contrary, the U.S. government should insist on the removal of the VER. □

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Legal Aliens
Toward a Positive Immigration Policy

Barry R. Chiswick

FOR THE PAST DECADE the public debate on immigration policy has been dominated by the perceived need to control illegal immigration. With the passage of the landmark Immigration Reform and Control Act of 1986, which provides amnesty for certain illegal aliens and penalties against employers who hire illegal aliens, this debate has, at least temporarily, come to an end. Public policy discussions regarding immigration should now turn to the criteria used in the admission of the roughly 600,000 aliens granted permanent resident status each year.

The United States admits legal immigrants for two primary reasons. The first is humanitarian. To aid those in distress, we accept refugees—persons with "a well-founded fear of persecution" for political, racial, religious, and other reasons. We also accept the immediate relatives of U.S. citizens; it pains us to allow political boundaries to separate parents from young children and husbands from wives.

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The second reason is economic. One function of immigration over the years has been to promote U.S. economic growth by expanding the human resource base and by responding to periodic shortages of particular skills.

Unfortunately, current U.S. policy for issuing non-refugee immigrant visas advances neither equity nor economic growth. Little effort is devoted to discovering the value of the visa to the immigrant, or the potential value of the immigrant to the United States.

Current Policy

The current system for regulating the flow of legal immigrants is based on the Refugee Act of 1980 and on the 1965 Amendments to the Immigration and Nationality Act of 1952. In spite of periodic criticism of the way in which the Refugee Act has been implemented, particularly with regard to Central Americans, there is general agreement that the law has put U.S. refugee policy on a sounder, fairer, and more humanitarian footing. On the other hand, U.S. policy regarding

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non-refugee immigrants is troubling. These visas are issued largely on the basis of kinship with a U.S. citizen or resident alien, with very little weight given to an applicant's likely contribution to the U.S. economy.

According to data compiled by the Immigration and Naturalization Service, which is summarized in the table below, of the 601,708 persons who received immigrant visas in fiscal year 1986, only 23,162—or a mere 3.8 percent of the total—were admitted on the basis of their skills, under the third and the sixth preferences. Of these, 11,763 were admitted as "professional or highly skilled immigrants" and 11,399 were admitted as "needed skilled or unskilled workers." These immigrants were accompanied by 30,463 spouses and minor children, for a total of 53,625 immigrants.

Individuals admitted under occupational preferences are a key source of skilled immigrant workers. Of the 8,389 engineers who immigrated to the United States in 1986, 40 percent were occupational-preference recipients, as were 40 percent of the 1,315 natural scientists, 52 percent of the 1,042 mathematical and computer scientists, 28 percent of the 4,619 nurses, and 38 percent of the 2,717 college and university teachers. These people contribute to our effort to remain at the cutting edge in the development and implementation of new technology, thereby creating employment opportunities for less skilled workers. They help staff our hospitals and nursing homes, particularly in the less advantaged inner-city neighborhoods, and they teach in our colleges and universities, thereby contributing to the development of a more highly educated population.

The Past vs. the Present

Current immigration policy places too much emphasis on kinship as the basis for rationing non-refugee visas. This emphasis dates to the 1965 amendments, which were enacted during a period when economic conditions were very different than they are today. In the mid-1960s, we had unprecedented productivity growth, shrinking unemployment, rapidly expanding real GNP per capita, and low and declining real energy costs. Most important, Americans believed all of these trends would continue indefinitely. In such an environment it might have been appropriate to downplay economic considerations in formulating immigration law, and to expand the scope for immigration based on kinship with a U.S. resident. The result, however, is no longer relevant to our nation's economic situation. The slow rate of economic growth and the country's declining position as a world leader in technology and international competitiveness require a rethinking of all policies, including immigration.

Current immigration policy places too much emphasis on kinship as the basis for rationing non-refugee visas.

There is another way in which the past differs from the present. There was a time, not too many years ago, when immigration to the United States was a gut-wrenching experience. It meant the virtual severance of all ties with family members who remained behind. That is no longer the case. The real costs of transportation and communication have plummeted. It is now relatively inexpensive in both time and money to fly to Europe, Asia, or any place in Latin America. Thanks to modern technology, international telephone communication is quick, clear, and cheap. And although postal services in every country are charged with being slow and inefficient, this is largely because our rising expectations out-distance their performance. Furthermore, the United States and most of the countries from which the United States receives immigrants have very few restrictions on nationals from one country visiting another. This has become a small world in which family ties can be maintained with relative ease even when family members live in different countries or even different hemispheres. These developments call into question the need, and the wisdom, of some of the kinship categories in the preference system.

Rationing Visas

Currently the number of visas issued each year by the United States is far less than the number of visas demanded. A non-price rationing scheme, based primarily on kinship, is used to allocate the limited number of visas among applicants. Those with a relative in the United States have a far better chance of obtaining a visa than do other equally meritorious—and possibly

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KEY PROVISIONS OF U.S. IMMIGRATION LAW AND NUMBERS OF IMMIGRANTS ADMITTED

IMMIGRANTS SUBJECT TO NUMERICAL RESTRICTION		NUMBER OF IMMIGRANTS ADMITTED IN 1986			
Category	Preference	Principals	Spouses/ Children	Total	Limit[a]
Unmarried adult children of U.S. citizens	First	8,711	2,199	10,910	54,000 (20%)
Spouses and unmarried children of permanent residents	Second	95,695	15,231	110,926	70,200 (26%) plus any visas not used above
Professional or highly skilled persons	Third	11,763	15,060	26,823	27,000 (10%)
Married children of U.S. citizens	Fourth	5,947	14,755	20,702	27,000 (10%) plus any visas not used above
Siblings of adult U.S. citizens	Fifth	24,837	45,564	70,401	64,700 (24%) plus any visas not used above
Needed skilled and unskilled workers	Sixth	11,399	15,403	26,802	27,000 (10%)
Non-preference (includes investors)	----	0	0	0	Any visas not used above
Other	----	404	0	404	----
Subtotal		158,756	108,212	266,968[b]	270,000 (100%)
IMMIGRANTS NOT SUBJECT TO NUMERICAL RESTRICTION					
Spouses, parents, and minor children of adult U.S. citizens		223,468	0	223,468	
Refugees and asylees		74,960	29,423	104,383	
Other		5,028	1,861	6,889	
Subtotal		303,456	31,284	334,740	
TOTAL		462,212	139,496	601,708	

[a] The annual limits on U.S. visas in all preference categories are 270,000 worldwide, 20,000 per country.
[b] Total admitted in a year may differ from numerical limitation because of unused visas and timing of entry.
Source: U.S. Department of Justice, *1986 Statistical Yearbook of the Immigration and Naturalization Service.*

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more productive—individuals. This creates real inequities among potential visa applicants, and undermines the potential value of immigration for bolstering U.S. productivity.

As shown in the table above, in fiscal year 1986, 24,837 brothers and sisters of U.S. citizens migrated to the United States under the "sibling of a U.S. citizen" preference category—7 percent more than the number admitted on the basis of skills. These siblings were accompanied by 15,321 spouses and 30,243 children, for a total of 70,401 immigrants. This compares with the total of 53,625 immigrants admitted under the occupational preferences.

The important question . . . is how to allocate immigration visas to accommodate both the humanitarian and the economic objectives.

The important question from the standpoint of public policy is how to allocate immigration visas to accommodate both the humanitarian and the economic objectives. For the purposes of this discussion, it is assumed that adult citizens of the United States will be able to bring to this country their bona fide spouses, minor children, and aged parents without numerical limit, and that refugees will be treated separately, as under current law.

A Skill-based System

One alternative is to ration visas on the basis of labor market skills. Such skills might include any of a number of characteristics demonstrated to enhance an individual's likely productivity in the United States.

The multidimensional aspects of skills can be combined into a single index for rationing immigration visas by a point system. A list of readily measurable characteristics that are expected to enhance the productivity of immigrants could be developed, and points could be assigned for each characteristic to reflect the applicant's traits. Points might be awarded for each level of schooling completed; for knowledge of English; or for apprenticeship training, vocational training, or relevant on-the-job training. They might also be awarded if the visa applicant were to be accompanied by a spouse with a high level of skill.

In addition, the system could award points for plans to invest in and manage a U.S. business. This would provide a clear recognition of the importance of new investment to the creation of jobs for U.S. workers. Of course, any funds invested in the United States could be withdrawn after the immigrant received resident alien status, and this would have to be recognized in the design of the point system.

It is interesting to note that the 1965 amendments provided for the immigration of investors ("entrepreneurs"). The law put investors in the "residual non-preference" category. Unfortunately, as a result of a large increase in the demand for visas by the siblings of U.S. citizens, there have been no residual visas issued since 1978, and hence no investor immigrants.

A point system could also be designed to recognize the value of relatives already in the United States. A small number of points could be awarded, for example, to applicants with close relatives who will guarantee their financial support for a period of, say, five years. In this manner, applicants who fall short of the general productivity criterion by a few points, but who

HERMAN JAMES UNGER
IMMIGRATION
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"Business or pleasure?"

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would be of considerable value to their relatives in this country, would still be able to immigrate legally. Under current law, sponsors have no responsibility for their immigrant relatives, and as a result, there is no meaningful test of the value they place on their immigration.

To be broadly viewed as fair and equitable, this scheme should not award points on the basis of race, religion, ethnicity, or country of origin. In fact, the current ceiling on the number of visas that can be awarded to citizens of any particular country—20,000 numerically restricted visas per year—should be removed. This ceiling discriminates against applicants from countries with large populations and countries where a large proportion of the population wishes to migrate to the United States. In recent years, the ceiling on immigration has been binding for Mexico, China, India, Korea, the Philippines, and the Dominican Republic.

Under a point system, the total number of non-refugee immigrants would be regulated by adjusting the point requirements for a visa. A threshold number of points would be determined for each year or period of years based on economic conditions in the United States. This procedure would permit the tailoring of immigration to prevailing economic circumstances, which is not now possible. Applicants who met the point requirements would receive visas for themselves and for their spouses and minor children.

Canada, Australia, and New Zealand have all adopted point systems for rationing immigration visas. The result has been an increase in the skill level of immigrants and a broadening of the range of countries from which the immigrants arrive. Various "non-traditional" sources of immigration have now become prevalent. For example, Asian immigration to Australia and Canada has increased from trivial numbers in the 1950s to more than 40 percent of immigrants in the 1980s.

The U.S. experience with the occupational preferences is also instructive. Immigrants entering the United States under these preferences have higher skill levels than other immigrants. In addition, migration streams have been opened to people (primarily from Asian countries) who would otherwise have had little hope of immigrating because they did not have close relatives in the United States. This opening of new migration streams was most pronounced in the decade immediately following the 1965 amendments.

Visa Fees

Another approach, one that has a natural appeal to economists, is to "sell" or "lease" immigrant visas. The idea is to raise the money price of visas until the number of applicants more closely approximates the number of available visas.

Under current law, individuals who are lucky enough to obtain visas because they have relatives in the United States receive large windfall gains that are denied others. These economic rents accrue because of the limitations placed by the United States on total immigration and the absence of an effective system of rationing by price. Greater equity among visa applicants, and between immigrants and the U.S. population, could be achieved by replacing kinship criteria with a direct immigrant visa fee. The fee could be paid in a lump sum by either the applicant or the applicant's U.S. relatives. A fee-based system

Greater equity among visa applicants, and between immigrants and the U.S. population, could be achieved by replacing kinship criteria with a direct immigrant visa fee.

would enable U.S. citizens to capture some of the economic rents now accruing to immigrants.

There are two potential problems with visa fees, neither of which is insurmountable. First, because of capital market imperfections, some applicants may have difficulty borrowing to pay the fee, even though migration to the United States would be an efficient investment. Second, a one-time, up-front fee would tend to discourage migration for temporary or uncertain durations, unless the fee were partially refundable when the alien left the country. Both of these problems can be solved by annualizing the fee as a surcharge on the federal income tax. Aliens who are not working, who are without taxable sources of income, and who have no willing sponsors would be subject to deportation.

The investor provision in the U.S. immigration law, and similar provisions in the laws of other major immigrant-receiving countries, are indirect ways of rationing visas by price. A more open and explicit price mechanism, operated on a much larger scale, would be less likely to distort investment decisions.

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Immigration Policy and the Family

Some may argue that an immigration policy based on the applicant's potential contribution to the U.S. economy—either through a skill-based system or visa fees—is "anti-family." This is not the case. Immediate relatives of adult U.S. citizens (spouses, minor children, and aged parents) would be eligible for admission without a fee and without numerical restrictions. For other applicants, relatives in the United States could assist immigration by accepting the financial responsibility of serving as sponsors, financing the applicant's acquisition of skills, financing the immigrant visa fee, and arranging employment. The willingness of U.S. citizens and resident aliens to engage in these activities would provide a good test of the value they place on the immigration of their relatives.

Nepotism and Immigrant Origins

Differentiation on the basis of kinship is a feature unique to immigration law in this country. Nowhere else in U.S. economic or social policy does official nepotism take center stage over evaluating an individual on the basis of his or her own characteristics and behavior. It is a policy that is fundamentally contrary to U.S. traditions, as well as to this country's self-interest.

Basing immigration policy on the applicant's contribution to the U.S. economy does not, as some might believe, tend to favor European immigrants. Skill-based systems, such as occupational preferences in the United States and point systems in Australia and Canada, have opened immigration channels for applicants from ethnic groups and countries of origin which, for one reason or another, had not been present in previous immigration streams. In each of these instances, the shift to issuing visas on the basis of skill has tended to favor Asians rather than Europeans.

A First Step

In an impressive bipartisan action in March 1988, the Senate passed, by an overwhelming margin, an immigration reform bill (S. 2104) that would revise the legal system for rationing visas. The bill would create two new categories of non-refugee immigrants—"selected immigrants" (55,000 visas per year) and "investors" (5,000 visas per year)—and reduce the number of visas for the siblings of U.S. citizens (to 22,000 annually, with a temporary allotment of 30,000 additional visas to reduce the backlog). Selected immigrants would be identified through a point system, with points awarded on the basis of age, schooling, relevant work experience, and English-language skills. The investor category would provide visas for those who invest at least $1 million in an enterprise that creates at least 10 new jobs.

The bill represents the first small, tentative step in reducing the overriding importance of kinship and increasing the role of individual productivity characteristics in rationing immigration visas. Unfortunately, the House has not yet taken action on the bill.

Conclusions

Many people who immigrate to the United States each year on the basis of kinship criteria would not qualify on the basis of productivity criteria. The immigration of these less productive workers is at the expense of the U.S. population. The largest adverse impact may be borne by low-skilled or socially disadvantaged Americans, who face greater competition in the labor market and in the allocation of income transfers. An immigration policy based on productivity would reverse this pattern. By increasing the overall skill level and hence the productivity of immigrants, the overall economic impact of immigration would become more favorable. Greater public support for increasing the annual level of immigration would likely follow. □

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Corporate Takeovers

Who Wins; Who Loses; Who Should Regulate?

John C. Coffee, Jr., Joseph A. Grundfest, Roberta Romano, and Murray L. Weidenbaum

On December 3, 1987, during its 11th Annual Policy Conference in Washington, DC, the American Enterprise Institute convened a panel discussion on "Corporate Takeovers and Insider Trading: Who Should Regulate?" The panelists were John C. Coffee, Jr., professor of law at Columbia University; Joseph A. Grundfest, commissioner at the Securities and Exchange Commission; Roberta Romano, professor of law at Yale Law School; and Murray L. Weidenbaum, Mallinckrodt Distinguished University Professor and director of the Center for the Study of American Business at Washington University. The panel was moderated by Christopher C. DeMuth, president of AEI. The following discussion is drawn from these proceedings.

PROF. WEIDENBAUM: How should we regard takeovers? The prevailing view in the scholarly literature is that takeovers of major American corporations yield positive results because the shareholders usually benefit. I disagree.

Most economic studies of takeovers fail to answer, or even to ask, whether the new company performs better than did the separate parts. Those few that have tried to answer this question have concluded that takeovers are harmful.

Most scholarly studies focus on what happens to the market value of the target companies. Not surprisingly, the price of the target company's stock invariably rises during the takeover battle. On reflection, would we expect anything else? After all, what serious raider would try to acquire stock by offering less than the market price?

But the prevailing view in the economics literature goes beyond a restatement of the obvious. It also makes an heroic assumption: that the value of the target company rises because the new management is likely to manage more effectively than the old. Unfortunately this assumption is often mistaken for irrefutable fact. Why is it irrefutable? Not because empirical studies demonstrate the point. There is little evidence that tenderers have managed the businesses they acquired any more profitably than their peers or their predecessors. Rather, the presumption of greater productivity is supposedly irrefutable because it is the only conclusion consistent with the efficient-market hypothesis.

It is premature to conclude that stockholders generally benefit from takeovers. After all, for each seller there is a buyer. What happens to the stock of the firm that does the taking over? The answer to this question is downplayed in the takeover literature because the stock price of the acquiring firm usually declines after the merger is announced—sometimes substantially (between 5 and 42 percent) and sometimes imperceptibly (3 percent or less). All sorts of apologies

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are made for this inconvenient conclusion. Inevitably, some question the statistical methodology used, although it is the same as that used for the enthusiastically embraced findings that the share prices of target firms rise. In fact, the two sets of findings come from the very same researchers in the very same studies.

The widely held belief that shareholders generally benefit from takeovers does not withstand close scrutiny. There are winners and losers. But the results are counterintuitive: the owners of the "winning" firm—the buyers—lose; the owners of the "losing" firm—the sellers—win.

Furthermore, it is not clear that the takeover process benefits society. Of the studies that show the dollar amounts of the gains and losses to both groups of shareholders, several show net gains, and several show net losses. But few of these results are statistically different from zero. Thus one need not quarrel with the efficient-market hypothesis or with "event studies" to conclude that little net social benefit seems to accrue from the entire takeover process.

Many members of Congress are concerned over what they view as a rising trend of hostile mergers. Representative Peter Rodino, chairman of the House Judiciary Committee, for example, stated, "I think it is time for Congress to send a clear signal to corporate America that we will no longer tolerate unrestrained warfare between top managements for control of corporate assets."

But if we have learned anything from the long history of government regulation of business, it is that when Uncle Sam intervenes in internal business decision making, he usually does more harm than good. Regulation is likely to generate serious and often unexpected side effects—the "government failure" that so frequently accompanies attempts to deal with "market failure."

My preference is neither for new laws nor for a do-nothing approach. The proper answer to corporate takeovers can be found in the corporation itself.

In addition to "takeover artists" and "entrenched managers," there is a third private-sector force battling for corporate control, the firms' own boards of directors. These boards are elected to represent the shareholders. Their most important, but rarely performed, duty is to say no. The board of a bidding firm should oppose a prospective merger that would, over the long run, dilute the earnings of existing shareholders and, in the short run, reduce the market value of their shareholdings. Similarly the board of a target firm must decide when an offer for the corporation's shares is sufficiently attractive to accept over the protestation of the existing management.

If the raiders are opportunists, then management and boards of directors have given them the opportunity. The record is clear: if the board will not make the difficult choices that enhance the value of the corporation, the takeover artists will. Takeover mania is not a cause but a symptom of the unmet challenge. The complaisant director has not totally vanished from the boardroom. However, the increasing frequency of shareholder derivative suits to challenge board decisions makes future decisions less likely to be based on management's preferences.

PROF. COFFEE: Murray Weidenbaum has raised a valid point about takeover gains. He is concerned that takeovers may represent little more than wealth transfers from bidder shareholders to target shareholders, with no net increase in wealth. He points to studies by others that suggest that bidders lose significantly, and that since bidders are often much larger than target firms, there are likely to be net losses.

This is arguable. In fact, it has been argued for some time. But it is also susceptible to empirical resolution. We need data not only on the aggregate gains or losses to bidders or targets, but also on the gains or losses to matched pairs of bidders and targets. These data have only recently become available. In a recent study Michael Bradley, Anand Desai, and E. Han Kim of the University of Michigan Business School examine the combined wealth effects for all takeovers in which the bidder and the target were publicly held and for which data on stock prices were available. This is a set of 236 matched pairs between 1962 and 1984.

Bradley, Desai, and Kim find that over the entire period, the combined value of target and bidder firms increased by about 7.5 percent. In three out of four cases, the gains exceeded the losses. This leaves one out of four cases in which the net impact of the takeover was negative, meaning the shareholders of the bidder lost more than the shareholders of the target gained. The average dollar gain per takeover over the whole period was $117 million.

Even more interesting than the aggregate data is the breakdown into time periods. During

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the 1960s, acquiring firms made statistically significant gains from takeovers. During the 1970s, however, they made no statistically significant gains or losses.

What has happened in the 1980s? From 1981 to 1984, for the 52 matched pairs, the combined value of bidder and target firms increased by 8 percent, or $219 million per takeover. This higher average gain reflects the larger size of targets. The most interesting finding is that bidders are incurring statistically significant losses: about 3 percent of their market value, or about $27 million per takeover.

The evidence is clear. That bidders currently lose from takeovers is not a myth. In only about 35 percent of the cases do bidders break even or do better. In nearly two-thirds of the cases, bidders' stock tends to go down. Still, over the entire period, the net effect of takeovers is strongly positive. Although some shareholders lose, on average, takeovers help shareholders.

I think it is a mistake to focus on bidder shareholders versus target shareholders. Shareholders hold diversified portfolios. They do not know whether they are going to hold stock in a target or in a bidder; because they are diversified, they know that, on balance, they will do well.

Isn't it curious that the new state statutes give target shareholders more protection, when the only victim is the bidder shareholder?

The pattern of gains and losses is also very unstable. One would not expect the world to remain in one position forever, with bidders regularly losing two-thirds of the time, and target shareholders regularly reaping very large gains. One would expect the world to change in many ways, possibly with takeover pressure beginning to focus on unsuccessful bidders.

Moreover, if bidders lose, so what? Loss is a basic fact of entrepreneurial life. Four out of five new restaurants that open in Manhattan this year will probably fail within two years; yet we do not ban new restaurants. We generally believe that social gain accrues when people take entrepreneurial risks, even if some individuals incur losses. The same applies to takeovers. And isn't it curious that the new state statutes give *target* shareholders more protection, when the only victim is the *bidder* shareholder?

Let me move from what we know about takeovers to what we do not know. We do not know what motivates bidders. The source of takeover gains has long been a mystery. Certainly some managerial theories about perverse incentives seem plausible. But there is a new debate brewing among economists. Financial economists, on the one hand, do stock price studies, and they invariably find that, on balance, target stocks rise. Industrial organization economists, on the other hand, study the assets of the target firm, one to three years after a takeover. They find no evidence that target assets are better managed after takeovers. Their findings are strongly inconsistent with the view that bad managers are being replaced by better managers.

So we have a puzzle. Shareholders clearly gain, yet there is no evidence that the assets are better managed. Although there are many problems with defining the criteria for better management, we can conclude that shareholder gains do not necessarily translate into social gains.

It is possible that other people are losing. The most likely candidates—aside from creditors, who can protect themselves—are probably managers, particularly middle managers who are not usually the beneficiaries of golden parachutes. I am not arguing for legislative protection, but I probably am arguing for greater tolerance for self-help remedies, such as the newly popular tin parachute. This is a direct self-help response to the problems that arise in this rather unstable world.

Another such response is the leveraged buyout. I believe that the leveraged buyout will become more and more frequent, and that increasingly hostile takeovers will be the precipitating force. What seems to be moving takeovers in the last five years is negative synergy, that is, the creation of value from breaking up conglomerate firms.

PROF. WEIDENBAUM: Jack Coffee is letting off the hook too easily the prevailing finance literature on takeovers, exemplified by Michael Jensen's widely cited article in *The Harvard Business Review*. This article, and others in its tradition, refer to event studies as science, and to everything else as fiction. The data showing that target shareholders gain are said to be sound. The data showing that bidder shareholders lose

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are said to need further examination. They then firmly conclude that the economy benefits because takeovers are good for shareholders.

This has been the prevailing view in the economic finance literature. I am glad to see it becoming more reasonable, but let us not let those guys wiggle off the hook so easily.

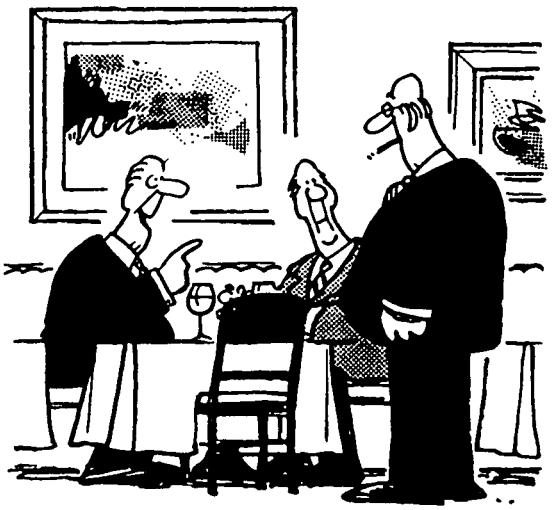
MR. GRUNDFEST: As an attorney and an economist, I would like to come to Jack Coffee's defense. We do not observe strong gains among bidders the way we do among targets. However, there are some fascinating patterns in the data. They suggest that market processes work in an evolutionary fashion to discipline acquisitors who engage in transactions that fail to add value in the marketplace.

Researchers at the Securities and Exchange Commission have discovered that aggregate data describing bidder returns mask significant differences within the population of bidders. In other words, while the average stock price effect on bidders' shares is close to zero, there are bidders with statistically significant negative returns and bidders with statistically significant positive returns. The bad bidders, those whose stock prices fall as a consequence of acquisition announcements, often become good targets themselves as the market later tries to undo their nonproductive acquisitions. These failed acquisitions often involve conglomerate strategies in which the buyer adds little, if any, operating value to the target firm. The market's subsequent attempts to discipline these transactions are often criticized as bust-up transactions even though they add economic value by creating more rational corporate forms involving less so-called conglomerate overhead.

Mergers and acquisitions are risky propositions. There is a Schumpeterian process at work as the market throws out the failures and tries to reward the successes. The problem with much of the legislation in the takeover area is that it would stop the operation of this evolutionary process. We would be trying to protect the failures, and at a very high price.

PROF. WEIDENBAUM: We agree on the public policy implications. No quarrel there.

PROF. ROMANO: Let me add a further wrinkle on the issue Murray Weidenbaum raises concerning the shareholders of acquisitors. A number of studies have found insignificant returns for bidders. This is not completely surprising. Competition among bidders reduces rents. Unless there were some unique synergies for a bidding firm, one would not expect a large positive return. More troubling is a finding of negative returns. Jensen argues—and I agree—that accounting data, which are used in the industrial organization literature, are unreliable. Accounting data can be a very poor measure of economically relevant information. Such data, for example, showed railroad companies doing well before they went into bankruptcy. So I understand the desire to use market price data as opposed to just accounting returns.



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"Say, isn't your company owned by the SAME COMPANY that owns mine?"

With respect to Murray's argument about boards, boards may not always be able to do what a bidder can. An interesting study by Randall Mørck at the University of Alberta, and Andrei Shleifer and Robert Vishny at the University of Chicago's Graduate School of Business bears on this. They found that when boards fire managers, the firms were doing poorly relative to their own healthy industry. But the targets of hostile takeovers are in industries that are doing poorly relative to the market.

I do not know how much to make of this, but it would suggest that boards can tell if their company is doing well compared to their competition. When the whole industry is doing poorly, a hostile bidder may be more effective than the board at breaking existing contracts with the

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work force, and taking other steps necessary to revive the firm.

I do not understand why management cannot do that itself, so I have mixed feelings about such a thesis. But even if we accept that view it is still possible to agree with Murray that boards can be better monitors of what management is doing.

PROF. COFFEE: We have hard data on bidders incurring significant negative stock reactions. This cannot go on forever. Bidders themselves may become the targets of hostile takeovers, a self-corrective response. Alternatively, boards may see a few vivid lessons and become more aggressive. I do not dispute anything that Murray said about directors being more aggressive. But that is an hortatory prescription, and I am not optimistic about it having a meaningful impact.

Why are bidder returns dropping to a negative level? Partly because, as Roberta Romano mentioned, we have a much more competitive market for corporate control. Most takeovers today result in multiple bids which compete away the rents.

But this would lead only to insignificant returns. What we may have here is a possibility raised by Professor Richard Roll, the hubris hypothesis, also called "the winner's curse." The person who wins an auction may well be cursed because he paid more than everyone else was willing to pay. He may have paid more because he had unique synergy gains available only to him, but he may just have been too optimistic.

One other point. Bidders that are incurring losses tend to be large corporate bidders. But bidders that break up firms and sell them off have not had losses. Ronald Perelman, for example, after taking over Revlon, broke up the company, paid off the junk bonds, and wound up with 40 percent of the assets absolutely free. This kind of negative synergy takeover is likely to continue. It will probably also precipitate more leveraged buyouts, because what bidders can do, managements can also do once they are under the gun.

One last point. It would be interesting to look at differences between the American and the English systems. In England, when Hanson Trust finances a takeover, it does not use junk bonds, but typically makes a subscription offering. English bidders in takeovers offer their own stock or use cash. That introduces some market discipline: if the market thinks the bidder is paying too much, or has a history of making overpriced acquisitions, the subscription offering will flop.

This equity subscription process has been very successful. English takeovers may have produced less of a winner's curse. I am not suggesting legislation of any kind, but it is interesting to see how a different system may have an internal brake.

The person who wins an auction may well be cursed because he paid more than everyone else was willing to pay.

MR. GRUNDFEST: There are substantial variations in patterns of bidder gains. It makes a big difference whether the bidders are specialists in the business, dabblers, or conglomerateurs; whether they are large or small; whether the deals are done for cash, as swaps, or as equity subscriptions. Even though the findings are preliminary, some trends are emerging. I suspect, for example, that the more subject the bidder is to market discipline, the greater are his gains. Cash deals are more subject to market discipline than swaps and thus may be correlated with superior performance.

Also stock prices often increase significantly when CEOs die. This "morbidity effect" occurs because problem CEOs are often perceived by the market as having hung around too long. When they die, stockholders often feel relieved. Two examples often cited in the popular press are Gulf and Western, and Resorts International, where the CEOs passed away unexpectedly and stock prices rose remarkably. This confirms Murray Weidenbaum's observation that boards do not always effectively discipline managers.

ROBERT H. MALOTT: I am the Chairman and CEO of the FMC Corporation. All of you have talked about the short-range value of takeovers to the seller, to the buyer, or to the shareholder, but I did not hear any of you address whether in the long run the takeover movement is positive or negative. Is the economy better off for having Phillips, Union Carbide, Borg-Warner, or other companies go through this process? Are those companies better off?

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PROF. WEIDENBAUM: I have a few observations, but no definitive answers to your questions.

First, I would have to say that Phillips and Unocal—their shareholders and maybe the industry—would have been better off if they had sold out to Boone Pickens. I do not think you can blame Pickens for the heavy debt load those two companies have. In the case of Phillips, it was a decision to perpetuate the management and to protect the community.

Second, it is hard to translate takeover battles into reduced performance on the part of American industry. I know there are many examples of companies forced to think and act short-term, but look at the aggregate data on research and development. In the 1980s, just as the takeover trend has accelerated, the private sector has displaced the federal government as the primary source of funding for research and development. This is a very encouraging shift, and it shows the long-term orientation of American business as a whole.

PROF. ROMANO: I agree with Murray Weidenbaum on this issue. Studies by the Office of the Chief Economist of the SEC and by Bronwyn Hall of the University of California at Berkeley have found that acquisitions do not have a negative effect on research and development expenditures. The SEC study also found that the market placed a positive value on announcements of long-term investments such as research and development.

MR. GRUNDFEST: I think Mr. Malott's question deserves a direct answer.

The question is whether all of these takeovers and restructurings are really good for the economy. The answer is that I can imagine more civil and less costly ways of achieving these restructurings where the investment bankers' and lawyers' fees would be lower, and where there would be less grief. But, given the way we do it today, is restructuring beneficial? Absolutely. Some of your own examples illustrate why.

Take the oil industry. If ever you saw a situation of screaming disequilibrium, it was the oil industry in the early 1980s. You could buy oil for $6 or $7 a barrel on the New York Stock Exchange and, at the same time, companies were investing in drilling projects that made sense only if the price of oil were to rise to $35 or $40 a barrel. That is disequilibrium in anybody's book. The companies taken over usually had bloated exploration budgets and were not very effective in finding new oil. I do not want to say that hindsight is the right way to judge anything. But in this case the market's judgment was right.

PROF. COFFEE: There are multiple perspectives on the assertion that bust-up takeovers occur because the liquidation value of assets substantially exceeds the market value.

In the "go-go" market of the 1960s, two small companies could somehow be put together into a conglomerate to produce positive synergy. Oliver Williamson, the leading theorist in this area, explained why the conglomerate was an efficient response to market conditions then.

Today the market believes that the conglomerate is an inefficient dinosaur. Substantial market pressure forces companies to define more narrowly their products and services, and their area of special competence. Even companies not threatened by takeovers are selling off their peripheral activities in a belief that the stock market will value them more highly if they focus on their core business.

What is behind that? One possibility is negative synergy. Somehow the large conglomerate has gone beyond its most efficient or optimal span of control. Another possibility is the free cash flow theory, which maintains that managers of conglomerates cross-subsidize their losing division with profits from profitable divisions. Spinning off divisions disciplines managers.

I see no great social harm in reducing the span of activities of the large conglomerate. That is occurring, and would be occurring even without the takeover. Exxon, for example, is repurchasing shares even though it does not feel threatened by takeovers.

I think the takeover is the most powerful force toward this shrinkage. The downside is that takeovers disturb the nexus of contracts that used to exist in the firm, disrupting some of the implicit contracts that bound managers to firms and gave them reasonable expectations of lifetime employment. Managers are now in a much more unsettled world.

MR. DeMUTH: I would like to ask the panel whether there are any areas of potential abuse or other problems that warrant attention from legislators. Can you identify areas that require public policy intervention?

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MR. GRUNDFEST: Our system today is far from perfect and much can be done to improve it. The most important improvements may involve a shift away from across-the-board rules that regulate all corporations identically, and toward a system of self-determination that allows each company's stockholders and management an opportunity to define the rules under or by which it will respond to takeover proposals.

We must have a flexible system that can reach judgments on a case-by-case basis. The government must look toward "private ordering," where the interests involved in the operation of the corporation can establish for themselves rules of governance and patterns of behavior that define how corporations will be taken over. I can see no reason for making the rules for takeovers the same for every corporation in the United States.

PROF. ROMANO: Let me reemphasize what Jack Coffee mentioned. We really do not have a good theory of acquisitions. With limited understanding, we should be very hesitant about enacting federal laws to affect acquisitions. There are at present several varieties of state takeover laws. If we knew what the ideal statute was, then there would be more uniformity as all of the states would have adopted it.

PROF. COFFEE: Is there a potential for abuse? We have focused on shareholders. I agree with the rest of the panel that shareholders are not being abused. In fact, they are making out like bandits. Takeovers increase shareholder wealth tremendously. Self-help or private-ordering remedies such as the fair price charter amendments, the poison pill—if approved by stockholders, and the super-majority provisions can promote stockholder interests. The increasingly competitive market for control under which a low bid simply triggers an auction also protects them: the greatest defense against exploitation through inadequate tender offers is that someone else will make a higher tender offer. We have seen a very competitive pro-auction policy in this area. The Williams Act, in effect, facilitates auctions by stretching out the time period.

From this standpoint, shareholders do not appear to be abused. That is the irony—every reform proposal that we see today, including the 15 state statutes that have been passed just since April, are premised on the myth that shareholders need protection. The problem is excessive defense, not inadequate tender offers.

WILLARD C. BUTCHER: I am the Chairman and CEO of Chase Manhattan Bank. In this discussion, we have spent a lot of time focusing on whether takeovers enhance shareholder value. I would just submit that the shareholder is not the owner, but a speculative renter.

When we think of owners, we might imagine a 19th-century mill owner in New England who had a long-term responsibility not only to the company but also to the community. Today we have institutional investors. If directors or managers consider only their own interests, they will sell out on every single takeover offer that enhances shareholder value.

It seems to me that shareholder value is not the issue. I represent a company that was incorporated before corporation law. I recently read the charter, and nowhere does it mention enhancing shareholder value. We have a broader societal issue here: what is really good for building economic capability in the country? That is why we have corporation laws in the first place. It is not just an issue of enhancing shareholders.

Are we better off because there is no St. Regis Paper or Continental Can Company? Is the economy basically better off?

I have not heard much about that. If it were merely a case of enhancing shareholder value, every CEO in this country nearing retirement would put his company into play. Their stock options would be worth a great deal more. And yet they do not do that. I do not want to attach either noble or stupid motives to CEOs. But there are broader issues.

PROF. COFFEE: I think there is something in what you are saying. Maybe you have stated it too broadly, though, by focusing on institutional investors.

You mentioned St. Regis disappearing. I think there is a danger of reifying companies and treating them as the real players. We have to decompose the corporation and look at its various constituents—creditors, employees, managers, and shareholders, only some of whom are institutional investors. Institutional investors are often pension plans such as the California State Teachers' Retirement Plan. People are ultimately the beneficiaries of these gains. These gains flow through institutions.

(Continued on page 47)

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Wiring the Constitution for Cable

Thomas W. Hazlett

WHAT IS CABLE TELEVISION? To consumers, cable is an opportunity to double and redouble the number of viewing choices. Cable News Network (CNN) beckons with 24-hour news, Entertainment and Sports Programming Network (ESPN) with round-the-clock sports, and Home Box Office (HBO) with first-run movies, comedy, and high gloss specials. Already 51.1 percent of Americans have been liberated from the broadcast networks by subscribing to cable.

Cable is a choice, hardly a necessity (although at least one federal inmate has filed a motion that his uncabled prison cell was an unconstitutional violation of his right to escape "cruel and unusual punishment"). Over 40 percent of households that are passed by cable, pass it up. Moreover, rival choices abound: broadcast television and radio; newspapers, magazines, and books; movie theaters; home satellite dishes; microwaved multichannel pay television packages; and that great competitive predator—the videocassette recorder (VCR). Indeed the Federal Communications Commission (FCC) has determined that "effective competition" exists in the cable marketplace if but one cable company co-exists with three or more over-the-air broadcast television channels.

Yet what appears to the consumer to be a nifty new competitor for broadcast television's network triopoly looks, to the local politician, like just another public utility operating a local monopoly. Like a utility, a cable company generates a product in one particular location (at the point of its satellite dishes and head-end electronic translating equipment) and sends it by wire to every subscribing home in the service region. The cable is tacked to telephone poles or electric utility poles, or buried in underground conduits. Cables cross avenues and utilize public rights-of-way. Signals are generated and transmitted on an electronic grid, overlaying the landscape to serve a precise geographic plot. To local politicians cable television looks like the telephone company.

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The Federal Perspective

Initially the FCC saw cable, from its humble beginnings in Mahoney City, Pennsylvania in 1948, as a useful extension of the household television set. Cable was first used to facilitate reception where long distances or bumpy topography blurred the VHF-UHF band. It seemed to be nothing more than an extremely long antenna wire; indeed it acquired the name Community Antennae Television ("CATV" in industry jargon). Accordingly the FCC, in an unusual show of regulatory restraint, left cable alone in the 1950s.

The FCC's view changed markedly around 1960. Cable was growing and beginning to encroach upon the *real* television market: broadcast television. The National Association of Broadcasters wielded formidable clout, and to

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them cable was competition. The FCC received that signal without interference: Competition with broadcasters was bad, and should be suppressed by regulation. The agency saw clearly that enhanced consumer choice was detrimental to its own larger objectives in overseeing radio and television; reducing the "exclusivity" of a broadcast license concomitantly lessened the FCC's regulatory leverage via the licensing process. Cable became just one more of the FCC's heavily regulated industries.

Until the mid-1970s, no cable company could legally build a system to provide more than two new signals to any home within the 50 largest television viewing markets. That is, a company could string cable but it could only sell channels that were already available over-the-air plus two (and one of those had to be from the nearest city). The FCC also drafted a host of arcane and anti-competitive regulations, including the rule that cable systems could not contract with pay channels to show any feature films less than three years old or more than ten, to offer live or even recent sporting events, or to produce any regular series.

Federal efforts to suppress competition from cable ended during the deregulation movement of the 1970s. The shackles were broken by a series of FCC and federal court decisions since 1972, and by the Cable Communications Policy Act of 1984. The importing of distant signals was allowed without limit and programming restrictions were lifted. Moreover, local government control of cable began to be limited. Municipalities were prohibited from collecting any more than 3 to 5 percent in gross cable revenues as a franchise fee; rates charged for the new "premium services," such as HBO, Showtime, the Movie Channel, the Playboy Channel, and the Disney Channel, could not be regulated, nor could basic cable prices; and municipalities were prohibited from stopping cable's new competitors. The FCC now saw the use of many zoning and franchising ordinances as naked protection of cable monopolists to the detriment of consumer choice, and this time it took the side of consumers.

The Picture at City Hall

In the late 1970s, just as the federal government was celebrating competition in cable, a new posse of regulators galloped in to capture the potential benefits of protected monopoly. Federal deregulation had finally given the cable industry something to sell in urban/suburban America, and the big-city franchises looked lucrative. Vast new programming selections—off both satellite and microwave—offered 30, 40, 50 channels of entertainment and promised a profit bonanza.

The FCC now saw the use of many zoning and franchising ordinances as naked protection of cable monopolists to the detriment of consumer choice.

Cable companies lined up at city halls to get permission to install cable in all big-city markets.

For the local politician, the competition for permits was the best cable program of all: the city council would produce its own auction. Municipal authorities could take bids for the right to wire city streets. Bidding would offer political benefits in the form of generous public access and local origination subsidies, and distribution, via equity shares, of legally protected profits. But the *quo* for these *quid* would be the exclusive right to supply cable free of competition—and that would require the city government to bar any cable competitor that had not been carefully selected, and charged, for the right of entry. The stronger that monopoly promise, of course, the more enthusiastic the rivalry for the politically awarded franchise.

To strengthen their monopoly promises, cities did suspiciously anti-consumer things, like using zoning ordinances to prohibit private cable systems from crossing *private* property lines. Private cable systems, called Satellite Master Antennae (or SMATV), and satellite dishes (called TVRO, "television receive only") were rudely quashed by local authorities in many jurisdictions despite the fact that they never encroached upon public property. Dallas attempted to keep a SMATV operator from competing with its established cable monopolist. The City and State of New York attempted to disrupt the state-of-the-art, 108 channel SMATV system brought in by the developer of the world's largest apartment building, Co-op City in the Bronx.

After years in court, these governments lost. After all, private, not public, property was at stake. Yet the incentive to intervene remained. As John V. Lindsay said, as mayor of New York

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City, cable franchises "were urban oil wells under our city streets."

With local officials acting as monopoly creators and protectors, the bidding for franchise rights became frenetic. Cable companies offered huge, exotic, space-age systems; generous fees to cities; vast payments to community groups; and healthy political contributions on either side of the table. They also routinely offered cable stock to well-connected city hall dons, a practice called "rent-a-citizen." One councilwoman in Denver claimed that during her city's wild 1982 franchise competition, the only person she personally knew who did not own cable stock was the coach of her son's little league football team—but then, he did not live in Denver. In Milwaukee, a company angling for the cable award retained two local political consulting firms, one to pitch its case, the other not to pitch any competitors'. Little wonder that, after a nationwide FBI investigation turned out case after case of franchising abuse, U.S. District Court Judge Susan Getzendanner commented in 1985 (while sentencing a Washington lawyer for making illegal payments to a suburban Chicago town official), "I think it was a bribe, and apparently what goes on in the cable industry all the time."

The Price of Urban Oil

The consumer welfare costs of lobbying for and receiving a franchise can amount to between 20 and 30 percent of the average customer's bill. If the typical cable consumer pays $25 a month for basic service and one premium channel, $5 to $7 of that can, in the bigger (more political) cities, be attributed to politically imposed costs, most of which are pure economic waste: $1 for the Cubs and Dodgers on WGN; 5 cents for the mayor and his friends; 20 cents down the drain.

There are other problems with cable franchises too. As the eminent constitutional law scholar from the University of Chicago Law School, Professor Philip Kurland, has noted:

> At one time local politicians saw cable television as one big barrel of pork out of which they would enrich their communities and, occasionally at least, themselves . . . .It was for them the solution to unbalanced budgets and high bond rates. It was to be a cornucopia. Unfortunately for them, however, in taking this view they overlook two things: reality and the Constitution.

The reality is that the great promises of cable systems that entertained your kids, mowed your lawn, and paid your taxes were not realistic. For example, the 1982 Sacramento franchise, awarded to United Tribune Cable Company, included, among other things, a promise that UTC would plant 20,000 trees and spend "$90 million in construction projects, local studios, and job training programs." When the franchise proved economically infeasible, residents of Sacramento went without cable for several more years.

Politicians found that negotiations before an award were easy. The promises flowed like cheap wine. But after the franchise was announced, a period of renegotiation usually ensued. The proud and even boastful cable franchisee would ever so meekly announce that all those fabulous features it had wanted to provide were really quite reckless financially and, indeed, impossible; it just had to be let off the hook. The next step was what those in the cable business refer to as "give-back" talks.

Judge Susan Getzendanner commented in 1985 . . . , "I think it was a bribe, and apparently what goes on in the cable industry all the time."

Customarily, two franchises are negotiated—one that the people see and applaud, "Film at 11," and another that the local politicians and the cable businesses later work out quietly, replete with give-backs. In 21 of the 30 largest television markets in the United States, cable franchises have been renegotiated after initial franchisings. Eight of those 21 were renegotiated before a single home was wired. This process routinely lasts two to four years, and sometimes far longer. Philadelphia has had four rounds of franchising since the late 1960s and, as of 1986, still had no cable. New York City, despite a series of studies and commissions of cable in the late 1960s, was only 20 percent wired as of mid-1987.

Milwaukee may be typical. As *Channels of Communication* magazine wrote in March 1986 of Milwaukee's franchising decision, "The goal was to base their selection of cable operator, as much as possible, on the merits of the bids." But how do you politically evaluate a service as com-

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plex, dynamic, and subjectively valued as cable television? "To many aldermen," the magazine noted, "the two [final] bids [of six cast] promising to build sophisticated systems and charge attractive rates were essentially identical. So the politicians went with what they knew best, which was politics. Warner Amex had a magnificently well-wired team." As the lawyer for the losing competitor conceded, "Why would you want to take what was regarded as a great prize and award it to strangers from somewhere else?" The magazine concluded, "The dream had been to pick a cable operator on the merits. The reality was that, without any illegality, politics carried the day."

Two important footnotes complete the message of Milwaukee: First, the 108 channel system called for in the franchise was renegotiated to a 54 channel system seven months after the award, and instead of 61 channels of basic service for $4.95 monthly, customers ended up with 35 channels for $11.95. That is a give-back. Second, on July 13, 1986 the *Milwaukee Journal* reported that the FBI had announced it was investigating allegations that "hundreds of thousands of dollars were funneled into Milwaukee for cable payoffs during 1982"—the franchising year. One councilman had already resigned.

The Constitutional Question

Beyond the political economy of cable franchising is its raw rub on the U.S. Constitution. What exactly does it mean to have local officials presiding over the question of who will be allowed to enter the local cable television business? Cable companies are no longer simply community antennae; they are editors and publishers—selectors of news, information, and entertainment services. Increasingly they cablecast local news in competition with broadcast television, radio, and newspapers.

Imagine a local government commissioning a "needs assessment" study, issuing a request for proposals, hiring a consultant to evaluate those proposals, holding public hearings—and then awarding a single *newspaper* franchise to the company which best served the needs of the community. This would be unconstitutional even if the government study concluded that only one local newspaper was economically efficient or likely to profitably survive. The courts, including the Supreme Court, have strongly affirmed the First Amendment rights of cable operators as electronic publishers. Courts are now viewing cable television not as a public utility, tightly controlled and accountable to local or state government, but as the equivalent of a newspaper—a view radically at odds with the way in which cable is franchised in literally thousands of U.S. communities.

As legal protection emerges for competitors to challenge incumbent monopolists, cities typically respond that cable is a "natural monopoly." Their franchising process is not the creation of exclusive privilege, they argue, but merely a good faith effort to limit the ravages of market-mandated monopoly, and to force franchise holders to serve community interests. But no newspaper could be licensed on the premise that, due to the "special economics" of the industry, monopoly was natural. In the 1974 *Miami Herald* v. *Tornillo* decision the U.S. Supreme Court unanimously established that the First Amendment trumps "natural monopoly." And if local governments have sought a good faith suppression of monopoly power, why have they been so diligent in their efforts to suppress competition or so reluctant to relinquish control over entry when their ability to control rates has been taken from them?

Whether "natural monopoly" is a legitimate reason to franchise cable, and if so, whether this justifies the government's denial of competitive entry are questions with profound constitutional implications for the 5,000 or 6,000 municipal franchises currently cablecasting in America. In 1987 these questions went to a jury in *Pacific West* v. *City and County of Sacramento*. In a trial stretching over two months in federal district court, a jury of six heard voluminous testimony. They were told by the plaintiff that the right to compete in cable was not a privilege to be auctioned off by local politicians, that cable television was electronic publishing, and that suppression of entry was no less than government censorship. At the same time, they were told by the defense that the government had acted on behalf of the community—just as it had in creating a police force and a fire department—in getting Sacramento citizens the very best deal possible in cable. They were told that cable television was a "natural monopoly," and that, since competition would be wholly ineffectual, the people were lucky that their elected officials had selected the best firm, at the best terms, to provide services to them.

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At the conclusion of the trial the jury was asked by the judge to answer some key questions:

"Is 'head-to-head' competition among cable television systems unlikely to occur and endure in the Sacramento market? In other words, is cable television a 'natural monopoly' in the Sacramento market?" The jury answered, "No."

"Was 'natural monopoly' a sham used by defendants as a pretext for granting a single cable television franchise?" The jury answered, "Yes."

"Was 'natural monopoly' a sham used by defendants to obtain increased campaign contributions for local elected officials?" The jury answered, "Yes."

The first American jury to look at the cable franchising process in light of the First Amendment found the monopoly award odious—a "sham."

Those findings came in June 1987. In July, before the judge's verdict had even been entered, the City and County of Sacramento surrendered. Upon advice from the county's own lawyers, the cable commission opened Sacramento's 350,000 home marketplace to competition. (Similar verdicts quickly followed in Palo Alto and in Santa Cruz.) A newcomer must acquire only a license that sets forth standards regulating use of public rights-of-way, much like the standards that housing developers and commercial builders must comply with, and that guarantee their liability for using such rights-of-way. As of this spring competitive cable entry had forced the incumbent to slash prices and race to wire long-neglected neighborhoods. The market is now open.

Conclusion

Lucas Powe, professor of law at the University of Texas, has written in his brilliant new volume, *American Broadcasting and the First Amendment*, that the U.S. experience with licensing the electronic press has been a disheartening failure. He demonstrates that we have corrupted free and open debate in the 20th century in just the way the founding fathers feared when they objected to licensure by the British Crown in the 18th century. Powe sees the compromising of television and radio as a painful but wasted lesson:

> Has anything been learned from our more than half a century's experiment in regulating broadcasting? If we could go back to the beginning, would we do it differently . . . ? The history of cable regulation, from cable's inception in the late 1940's to the Cable Communications Policy Act of 1984, suggests that the answer is a resounding no.

Until the California decisions become the law of the land, the status of cable remains that of unregulated, franchise monopoly. Under the Cable Act of 1984 cities have been unable to control pricing or commercial offerings of cable operators (except a small number of systems in outlying areas). An official at the FCC recently noted, without a hint of irony, that there are just two things municipal cable officials may not regulate: one is price, the other is service. While the penchant to bar competitive entry into local cable markets makes little sense from the perspective of consumer welfare, cities still routinely leverage their police powers to capture the political dividends associated with controlling ownership rights to a lucrative medium. But auctioning the right to speak is not wholly within the spirit of the First Amendment. As Powe alerts us, "A city may protect its streets, but it may not control who sends messages or what messages are sent. Only the fact that cable is a newer technology could mystify this truth."

Perhaps the cable mystery is being solved. Courts, and particularly juries, will not like what they see when they tune in to municipal franchising on cable's new First Amendment channel. The right to compete in cable, as to publish a newspaper or to speak in the park, is not well served when awarded at the pleasure of incumbent officeholders. This theme is in its 201st year of reruns. It is older than the first satellite, and far ahead of the first Cubs' or Braves' game. Indeed we can thank the founding fathers for handily wiring our Constitution for cable. □

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Risky Products, Risky Stocks

Paul H. Rubin, R. Dennis Murphy, and Gregg Jarrell

AT LEAST TWO TYPES of information can show the worth of a firm: the accounting data that itemize assets and liabilities according to generally accepted accounting principles, and the price of its common stock. The stock market's valuation of a firm incorporates diverse information that accountants must ignore—ranging from the health of the world economy to the health of the firm's marketing vice president.

The costs of regulation are often measured in accounting terms. This information is useful, but in many cases it fails to reveal certain large costs that are very much on the minds of stockholders. In this article, we examine the costs of product recalls by the Consumer Product Safety Commission (CPSC) as reflected in the market value of affected firms. With well-functioning capital markets, stock prices provide a measure of the full costs of regulatory actions on firms and their shareholders.

Paul H. Rubin is vice president of Glassman-Oliver Economic Consultants and former chief economist at the Consumer Product Safety Commission. R. Dennis Murphy is an economist at the Federal Trade Commission. Gregg Jarrell is senior vice president of research, The Alcar Group, Inc., and former chief economist at the Securities and Exchange Commission. The authors' views do not necessarily reflect those of the commissions.

CPSC Recalls

The CPSC regulates all consumer products that are not specifically under the jurisdiction of other federal regulatory agencies. Since most dangerous products like automobiles, boats, guns, drugs, foods, cigarettes, and pesticides are regulated elsewhere, the CPSC is limited by law to regulating comparatively safe products.

Under the Consumer Product Safety Act, firms are responsible for informing the CPSC of "defective" products, which are defined as products that create "a substantial risk of injury to the public." Defects may be due to design problems that cause injury—a toy with a sharp point—or to potential for misuse—a toy hung above a crib contrary to warnings. After filing a report, the firm and the agency's compliance staff generally negotiate over alternative courses of action. Most often a plan of action is adopted "voluntarily" on the part of the firm and a joint press release is issued. If no agreement is reached, the CPSC can litigate. Depending on the agreement, the firm may pay refunds to purchasers, repair defects, replace items with non-defective units, or send warning notices to consumers.

The CPSC recalls about 200 products from the market each year, ranging from teakettles and hairdryers to snowmobiles and compressed gas cylinders. About half of the recalls involve violations of pre-existing CPSC standards, such

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as the health and safety rules for toys summarized in the box below. The rest involve unanticipated defects similar to the examples in the table on the opposite page. This article deals only with unanticipated defects.

Direct and Indirect Costs

Recalls impose both direct and indirect costs on the owners of firms. Direct costs include outlays for notices, repairs, refunds, and the like. These are the costs that would normally be measured in a benefit-cost analysis (were such an analysis conducted). Indirect costs, which are likely to be much larger, are associated with damage to the goodwill of consumers and the risk of product-liability suits. If consumers interpret a recall announcement to mean that a firm makes unsafe products, sales will suffer, as will the value of the firm's stock. Equity values will also be adversely affected if a recall signals a firm's increased vulnerability to liability suits.

Selected CPSC Toy Regulations

•*Small Parts.* Toys used by children under 3 years of age must not contain small ingestible parts.

•*Sharp Points and Edges.* Toys and other articles for children under 8 years must not contain sharp points or sharp glass or metal edges.

•*Pacifiers and Rattles.* Pacifiers and infant rattles must be large enough so that babies cannot choke on them, and must not come apart into small pieces.

•*Lawn Darts.* Lawn darts must not be sold in toy stores and must have labels to indicate they are not toys and could cause serious injury if misused.

•*Lead in Paint.* The amount of lead in paint used on toys and other children's articles must not exceed .06 percent. This limitation also applies to paint sold for home use and to paint used on furniture (except metal furniture).

•*Hazardous Chemicals.* Toys and other articles used by children must not be made with poisonous and otherwise harmful chemicals. Chemistry sets, model rocketry sets, model airplane fuel, and other products designed for older children, which by their very nature must have such chemicals, may be sold only if accompanied by instructions and warning labels.

•*Electrically Operated Toys.* Electrically operated toys and children's products must be designed to prevent shock and burn injuries.

Source: U.S. Consumer Product Safety Commission, "Product Safety Fact Sheet, No. 47: Toys" (August 1986).

Stock Market Response

With efficient capital markets, all available information is reflected in current stock prices; any new information, such as that provided by an unanticipated recall announcement, is quickly incorporated. Thus the cost to firms of product recalls can be measured by estimating the excess (or net-of-market) stock returns in a period surrounding the public announcement. Adjusting for market trends and for the riskiness of the particular stock, negative excess returns would imply that the firm was adversely affected by the recall, whereas positive excess returns would imply that the firm benefited. The magnitude of the excess returns provides a numerical estimate of the losses or gains borne by shareholders.

The sample of firms in our study is a subset of publicly traded firms involved in recalls for unexpected defects in the period 1977 to 1981. This sample covers 48 recalls for 31 firms. (Eight of the firms were involved in multiple recalls.) In examining the stock price effects, we used an 80-day event window spanning from 40 days before the recall announcement to 40 days after. This is large enough to ensure that any overreaction in the market to the news of the recall is corrected. Because our sample is limited to publicly traded firms, which are typically larger than average, our cost estimates should be higher in dollar (but not percentage) terms than the cost of the average recall. The sample of recalls is representative of CPSC recalls.

Recalls Impose Substantial Costs

On the basis of this research, we conclude that product recalls are very costly, resulting in large drops in the stock prices of affected firms. In the sample of firms studied, the average loss in equity value was 6.9 percent; on average, a firm loses about 7 percent of its net worth as a result of a product recall. Excess returns are negative in 73 percent of the cases examined. In dollar terms, the aggregate net loss from the 48 recalls was $7 billion. Six billion dollars of this total was due to one firm, Sears, which was involved in eight overlapping recalls. Even excluding Sears,

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losses averaged 5.4 percent of net worth, and excess returns were negative in 67 percent of the cases. Evidently the market imposes strong penalties on firms producing "defective" products.

These costs are much larger than we had expected. Most products recalled pose a relatively small risk, and the direct costs of the recalls themselves are usually small. For example, five of the cases in the sample involved hairdryers that were recalled for an extremely remote cancer risk from asbestos; even in these cases the stock price effects were generally negative.

While our estimates of the costs of CPSC recalls are surprisingly large, they are consistent with the results of studies of similar regulatory actions by other federal agencies. In a study by Sam Peltzman and Gregg Jarrell, for example, drug recalls by the Food and Drug Administration were found to result in a 6 percent loss in equity value, which is very close to the estimates here. Automobile recalls by the National Highway Traffic and Safety Administration were

Voluntary Corrective Action Plans for Unanticipated Defects
Selected Cases

Product*	Hazard	Action
Full Size Crib	Hardware may loosen, causing crib to collapse, possibly hurting, entrapping, or suffocating children.	Free replacement offered, but firm soon filed for bankruptcy.
Lawn and Garden Tractor	Steering wheel can separate from shaft, resulting in a loss of steering control.	Free repair offered.
Lawn Mower	Engine exhaust gas can deflect onto the brake control cable and defeat the "deadman" brake release.	Free repair offered.
Clothes Steamer	Base and heater assembly can separate from the product without warning, spilling boiling water on user.	Free replacement offered.
Coffee Percolator	Lid can be pushed into pot if not properly aligned, burning user's hands.	Free replacement offered.
Stroller	If stroller collapses, fingers may be trapped in folding mechanism.	New safety lock offered.
Aluminum Chair	Support rod may buckle and chair may collapse when consumer sits in it, causing possible injury to back, neck, head, and fingers.	Refund, repair, or replacement of aluminum rods with steel rods offered.
Piano Lamp	Bulb sits too close to plastic sleeving; may cause a fire hazard.	Free replacement offered.
Ceiling Fan	Blade arm may break and fly across the room, possibly striking someone.	Replacement of blade arms offered.
Fire Alarm	Unit may fail in the presence of smoke even though the test button proves positive.	Free replacement offered.
Kerosene	Kerosene may be contaminated with gasoline.	Recall issued.
Playpen	Neck or head may become entrapped, causing strangulation.	Recall issued.
Microwave Oven Turntable	Plastic hub may heat and soften, causing bottom to fall out when lifted; inner coiled spring could be released, injuring user.	Refund or replacement offered with $2.00 rebate.
Wheelbarrow	Wheel rim may split or tire may explode if tire is overinflated.	Recall issued.
Bunk Bed	Mattress and foundation may fall through frame, due to loose cross ties. Could result in death.	Free modification kit offered.

*Actions apply to specific brands and product lines.
Source: U.S. Consumer Product Safety Commission, *Annual Report, Fiscal Year 1986.*

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found to result in substantially smaller costs—about 1.4 percent of equity value. However, this lower figure appears to be due to the fact that automobile recalls are fairly common so the risk of a recall is generally anticipated. (A recent study by George E. Hoffer, Stephen W. Pruitt, and Robert J. Reilly questions this result.) In another study by Peltzman—the first event study of a regulatory action—deceptive advertising cases by the Federal Trade Commission were found to reduce the net worth of affected firms by 3 percent. This lower figure (though still high) reflects the less severe nature of the regulatory action, which is generally a cease-and-desist order.

Effects on Consumers

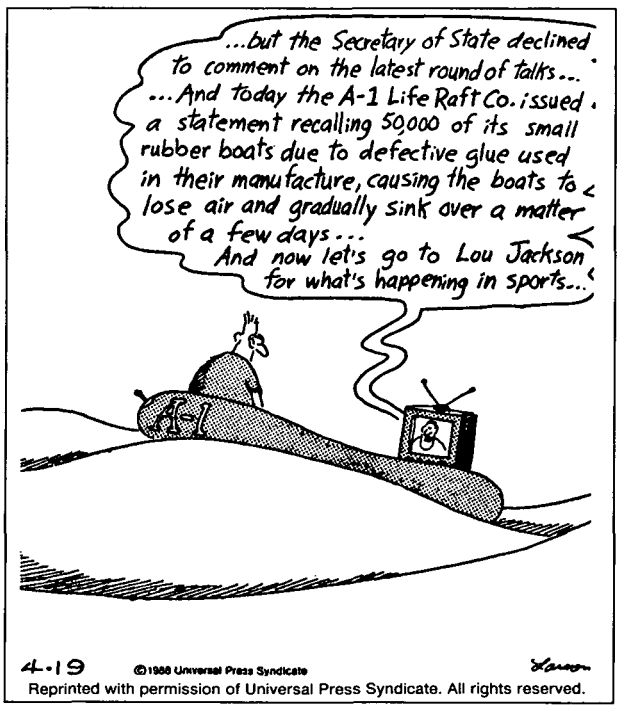
While the effects of product recalls on firms are interesting and important, ultimately we are concerned with the effects of government action on consumer welfare. Our analysis has two implications for consumers.

First, since the costs of recalls are ultimately borne by consumers, the net benefits of recalls are lower than might be indicated by numbers of lives saved, or sickness or injuries escaped. The CPSC imposes significant financial risks on firms producing consumer products and, consequently, increases their cost of capital. The higher the cost of capital, the higher will be the price of consumer goods.

Second, the health and safety benefits to consumers may not be worth the cost. A preliminary examination of the benefits of the recall program suggests that they are quite small. CPSC epidemiologists estimate that 25,000 deaths result annually from accidents involving all products under CPSC jurisdiction. Considering all recalls of defective products between 1984 and 1986—there were 279 products recalled, of which 20 had a measurable potential for causing death—we estimate that no more than 25 lives per year are saved as compared to the 50 or fewer lives lost annually as a result of these recalled products. Two-tenths of 1 percent of the deaths from CPSC-regulated products are due to correctable defects. In a separate study, W. Kip Viscusi has found that the CPSC has had no measurable effect on reducing product-related deaths, a result consistent with our findings.

Analyses conducted within the CPSC have shown that for products that are recalled, the compliance staff is just as likely to underestimate a risk as to overestimate a risk. This can result in anomalous situations where relatively low-risk products are given more publicity and are regulated more strictly than high-risk products. For example, one of the most severe risks the CPSC has dealt with through a recall in recent years involved an electric heater that was associated with fires. The heater had been erroneously classified as less risky than a toy that presented a much smaller risk of death. This can occur because recalls are not subject to an *ex ante* quantitative risk analysis.

Unjustified recalls can lead to increased risk in the market. If products are erroneously removed from the market, consumers' choices are unnecessarily restricted, and consumers have an incentive, due to higher product prices, to continue using older, more dangerous products. In addition, if consumers are led to believe that products are more dangerous than they really are, they will shift their consumption toward other (possibly riskier) goods or activities. Finally, because of the large number of recalls, consumers may be led to believe that accidents typically result from design defects, rather than the care with which they use products. As a result, they may be lulled into excessive carelessness. Although these costs could not be measured in our study, ultimately they may be the largest and most important component of the cost of product recalls.


...but the Secretary of State declined to comment on the latest round of talks...
...And today the A-1 Life Raft Co. issued a statement recalling 50,000 of its small rubber boats due to defective glue used in their manufacture, causing the boats to lose air and gradually sink over a matter of a few days...
And now let's go to Lou Jackson for what's happening in sports...
A-1
4-19
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Policy Implications

Recall decisions are far more costly than generally recognized, and certainly far more costly than indicated by the direct costs. The benefits of recalls—lives saved, or injuries or sickness escaped—may or may not justify these costs. Only if the benefits of correcting a defect exceed the costs should the CPSC recall a product and impose these enormous costs on owners of firms and ultimately on consumers. Cost-benefit analysis is required to make such a determination.

For a short time, the CPSC conducted cost-benefit analyses to determine the best policy, but only in cases where an agreement had not been reached between the firm and the compliance staff. Since there are few contested cases at the CPSC, there were not many cost-benefit analyses. Perhaps agency staff resisted wider use of this technique because they believed very few recalls would be found to have benefits that exceeded costs. If this were the case, and if product recalls would generally impose net harm on society, cost-benefit analysis should be required, not avoided. To date, the CPSC has not compiled sufficient data to draw any firm conclusions about the social value of individual recalls.

Unfortunately, with the passage of the 1988 CPSC appropriation bill, it became illegal for the CPSC to use cost-benefit analyses to determine if a recall will provide net benefits to consumers. The bill forbids the CPSC from spending any funds "conducting or reviewing cost-benefit analyses on enforcement actions." This provision should be repealed. All decisions regarding product recalls should be evaluated using a cost-benefit analysis. In the meantime, the CPSC should be very restrained in issuing recall announcements.

Sound public policy would dictate that the CPSC also give serious attention to reallocating resources within the recall program, and quite possibly, to reallocating resources away from the recall program to other activities. The goal should be to save more lives at lower social cost.

Another public policy implication of our analysis is that the CPSC should issue a *Federal Register* notice clarifying a statement it has made urging firms to report possible defects and suggesting that voluntary recalls may be beneficial to firms. According to the CPSC, "corrective action voluntarily undertaken by a firm has the beneficial effect of showing that the firm is responsible and concerned about high standards of quality." By suggesting that the costs of recalls are lower than they actually are, the CPSC could induce firms to underinvest in safety and hence produce too many defective products.

Conclusions

The CPSC spends about 15 percent of its resources on recalls, even though the defective products involved cause no more than two-tenths of one percent of the deaths associated with products under CPSC jurisdiction. This allocation of budget resources might be appropriate if, for example, defects were more easily addressable than other hazards. However, the evidence suggests that this is unlikely. Recalls impose large costs on firms and ultimately on consumers. Furthermore, given the large number of recalls (the CPSC may issue several messages a week about defective products), consumers may be led to believe that accidents are caused by defects rather than careless use, possibly resulting in increased risk. At present the CPSC has no way of determining which defects are most severe and most deserving of attention.

The only way to correct these problems is to perform quantitative analyses of the costs and benefits of all CPSC actions. This would enable the CPSC to improve the allocation of resources, and consumers could have greater confidence that products recalled for defects in fact had defects worth correcting. The current congressional ban on such analyses does not benefit consumers, does not increase safety, and should be removed. □

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Readings

Sins of Commission

Public Choice & Regulation: A View from Inside the Federal Trade Commission, Robert J. Mackay, James C. Miller III, and Bruce Yandle, eds. (Hoover Institution Press, 1987), 363 pp.

Reviewed by Daniel Oliver

I was among the noneconomists who cheered when a Nobel prize was awarded to James Buchanan. His pioneering work in the field of public choice helped dispel the myth that government is a black box automatically programmed to advance the public interest. His theoretical analysis provided an explanation for the conclusion that I and many others had reached through casual empiricism: government programs often fail to achieve their stated objectives.

Economists are not, of course, satisfied with casual empiricism. Give economists a little data and a computer and they will construct models with testable hypotheses, run regression analyses, and predict future behavior. Many of them seek to measure and to predict what often appears immeasurable and unpredictable to laymen. In large part, this is what the contributors to *Public Choice & Regulation: A View from Inside the Federal Trade Commission* have done. This volume, edited by Robert J. Mackay (an economist formerly with the FTC), James C. Miller III (former chairman of the FTC), and Bruce Yandle (former executive director of the FTC), contains 16 chapters, most of which use public choice theory to analyze the behavior of the Federal Trade Commission.

I approached my reading of *Public Choice & Regulation* with great interest. As chairman of the FTC I welcome any new insight into the workings of the agency, and this volume promised to be particularly helpful. It offers a positive analysis explaining what the FTC has actually done, rather than just a normative analysis explaining what the commission is supposed to do. In addition, 14 of the 16 chapters are authored by individuals who have worked at the FTC (many in senior positions). Here was an opportunity to see what would be revealed through the prism of public choice analysis.

The analytical chapters of *Public Choice & Regulation* fall into three major parts. Part I analyzes the relationship between Congress and the commission and explores the extent of congressional control over the commission. Part II examines the economic and political determinants of program activities at the FTC. Part III deals with internal management and budgeting—topics that will mainly interest FTC insiders and public choice scholars.

The first part of *Public Choice & Regulation* provides two statistical insights regarding congressional control over the FTC. We learn that the FTC regulatory agenda has conformed to the predilections of its overseers. The commission undertook activist regulatory programs when senators who received high ratings by the Americans for Democratic Action were on the Subcommittee on Consumer Affairs of the Senate Commerce Committee, and reduced its activism in 1979 and 1980 when the ADA ratings of those senators fell. We also learn that between 1961 and 1979 the commission systematically dismissed complaints brought against corporations headquartered in states represented by congressmen on certain committees and subcommittees overseeing the FTC (not, however, the Senate Commerce Committee).

In Part II we are told still more about the economic and political determinants of program activities at the FTC. During the period 1937 to 1981 the FTC adjusted the number of Robinson-Patman cases it brought according to the business cycle: during recessions it rescued businesses by bringing cases to stamp out price discounting; during expansions it reduced the number of such cases. From 1948 to 1981 the

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FTC and the Department of Justice colluded to eliminate competition between the two enforcement agencies—eliciting higher budgets from Congress for approximately the same number of cases. During the period 1970 to 1972 the commission established, maintained, and enforced its ad substantiation program to confer a comparative advantage on large firms. (By targeting industries where market shares and reputations vary widely, ad substantiation imposed a greater relative burden on smaller firms.) From 1968 to 1981 the commission subverted consumer welfare by settling cases against firms in concentrated industries while litigating against firms in more competitive industries. From 1968 to 1982 the FTC operated its merger enforcement program to maximize the welfare of staff attorneys. It brought challenges in industries already familiar to staff; weak suits were initiated, allowing staff to show output and increase their perceived value to future employers; most cases were then settled without effective relief because the staff did not want to litigate weak cases. The unevenness of civil penalties imposed by the FTC between 1972 and 1981 revealed that the commission's constituency was large rather than small business: civil penalties imposed on smaller firms constituted a higher percentage of annual sales.

What assessment should one make of this collection of information? In a final chapter, Gordon Tullock reaches modest conclusions: The market does not work well when there are large externalities; government does not work well anywhere but where externalities are large; the FTC's ostensible effort to control monopolies is a sensible solution to a number of problems but we should not expect a great deal of good to come out of a regulatory board. Government agencies justify their actions in terms of the larger public interest, but much of their activity is "devoted to generating particular benefits for small groups of people." In the case of the FTC, the identifiable interest groups that predictably affect the FTC, by their private actions or through intervention by Congress, are big industry, the FTC staff, and the FTC bar.

What would Tullock have us do? First, expect less. Second, use careful thought and a good deal of further research to design a set of public institutions that can produce an outcome truly to the public's advantage.

What conclusions do I, as chairman of the FTC, draw from reading *Public Choice & Regulation*? My initial conclusion is that the authors must be describing a commission from the distant past. After all, most of the data relates to the 1960s and 1970s. What other conclusion can I draw? Despite its warts, the FTC I see in operation looks somewhat better than the composite picture portrayed by the authors.

Yet sober second thoughts intrude. Economic incentives outside the agency have not changed: rent-seeking is still in style and congressmen still seek reelection. Within the agency, the economic incentives faced by the staff depend in part on guidance from the top. And while the Reagan appointees may have been good, they certainly have not created a new *homo bureaucraticus*. Therefore I may be deluding myself. Distasteful as the thought may be, I must entertain the hypothesis that I, an ardent deregulator, have been captured by the bureaucracy and the regulated industries and that I unwittingly further the pecuniary interests of large businesses and the career plans of staff attorneys.

If I accept all the chapters in *Public Choice & Regulation* at face value and assume that the patterns described are accurate and remain true today, I conclude that stronger medicine is needed than is prescribed by Gordon Tullock. Given the unflattering positive analysis, the appropriate normative prescription is abolition of the agency. What justification can there be for an agency that has created jobs for a specialized bar, colluded with its sister enforcement agency to acquire a larger budget, enriched large advertisers at the expense of the small, and challenged mergers that are not anticompetitive just so trial lawyers can enhance their human capital? Further, if the theory of one chapter is given credence, we should impeach or indict any commissioners and congressmen implicated in the systematic dismissal of cases against respondents headquartered in states represented by members of oversight committees. What justification can be given for granting immunity to firms, after their cases have been heard by an administrative law judge, simply on the basis of the political jurisdictions in which they operate? Though the authors of this particular chapter do not suggest corruption, their theory can hardly be understood on any other basis.

My legal training necessarily cools my ardor for reform and my righteous indignation at corruption. How, I ask, would a prosecutor prove the corruption implied by the systematic dismissal of cases? Can we put three economists on

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the witness stand to testify that the dismissal rates are statistically significant and cannot be explained by chance, leaving corruption as the only explanation? The thought of proving a criminal violation by means of statistical correlation forces a reassessment of *Public Choice & Regulation*. Economists and noneconomists alike understand that statistical correlation does not *prove* anything. Statistical evidence is only as good as the underlying theory, the relevant data, and the fit between them.

The FTC's performance during the past seven years belies certain predictions in *Public Choice & Regulation*, suggesting problems with either the underlying theories or the data used. Consider, for example, the accuracy of two of the book's predictions in light of evidence from recent history. Robinson-Patman antidiscrimination complaints are predicted to rise during a recession. Why did the number of such complaints not jump in 1982 and 1983? FTC enforcement patterns are predicted to follow the preferences of members of oversight committees. Why have the number of predatory pricing and resale price maintenance suits not risen since the oversight committees began requiring the commission to explain its disposition of every complaint regarding such alleged conduct?

Public choice is a powerful idea expounded by articulate individuals. But unless the concepts of public choice are used carefully, they trivialize the power of ideas and the importance of individuals. Ideas matter. Legal and economic thinking has changed regarding predatory pricing, resale price maintenance, and price discrimination. Knowledge of this fact permits better predictions of FTC performance than is afforded merely by statistical trends.

Individuals also matter. I am confident that a comprehensive history of the FTC written two decades from now will demonstrate that the commission performance served the interests of consumers better when economists such as James C. Miller III, Bruce Yandle, and Robert J. Mackay were manning the FTC. Was it their knowledge of public choice theory that made a difference?

Ironically the only article in *Public Choice & Regulation* written by a noneconomist— William Kovacic—provides evidence that the FTC's historical record cannot be understood without an appreciation of the evolution of and interaction among competing ideas. Kovacic's article is well worth reading first. Explicitly or implicitly, it raises basic questions about the FTC. Do President Wilson's ideas of the role of the FTC in 1914 meet the needs of the present? Does the concept of administrative expertise have any content? Is administrative law enforcement, subject to legislative rather than executive oversight, consistent with our Constitution? Which inflicts the greater harm on consumers: the market failures the FTC addresses or the FTC's remedies for these market failures? Is there a legitimate role for two federal antitrust enforcement agencies? Are there activities by the federal government that would predictably protect consumers?

Understandably these partly normative questions are left unanswered by *Public Choice & Regulation*. Some elements of an entirely convincing positive evaluation of the performance of the FTC are also missing. These weaknesses preclude any confident conclusion that the FTC's performance is governed by public choice, not the public interest. Although it is not totally convincing, the book provides numerous insights into past mistakes made by the FTC, mistakes that are consistent with public choice theory. Left for others is the normative task of evaluating whether the FTC should continue to exist. So long as it does exist, books like this provide some help for people like me to avoid the mistakes of the past.

Sharing Shortages

Responding to International Oil Crises, edited by George Horwich and David Leo Weimer (American Enterprise Institute, 1987), 313 pp.

Reviewed by David R. Henderson

In 1974, shortly after the Organization of Arab Petroleum Exporting Countries (OAPEC) imposed an embargo on the United States and on Holland, Secretary of State Henry Kissinger created the International Energy Agency, recruiting virtually all of the Western industrialized countries as members. One of the IEA's main purposes was to ensure that an embargo like OAPEC's could not happen again.

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This was ironic, since the OAPEC oil embargo, like all selective embargoes of fungible commodities, was ineffective. If Saudi Arabia and Iran refuse to sell to the United States but still maintain production, then they have to sell more oil to, say, West Germany. But then buyers in West Germany will buy less oil from Venezuela and sellers in Venezuela will sell more to the United States. Suppliers and demanders are simply reshuffled. The net result is that everyone pays a slightly higher price reflecting higher transport costs, but no differential cost is imposed on the target of the embargo. The only way a selective embargo can hurt badly is if production is cut. But then all consuming countries pay more for oil. Again, the targeted country is not differentially harmed. The "oil weapon," selectively used, is a dud.

Whether Henry Kissinger understood this is not clear. What is clear is that the IEA members worked out a plan and even an explicit formula for sharing the oil in the event of a 7 percent or greater cut in world output, a so-called supply disruption. Under the Emergency Sharing System (ESS), countries with allocation obligations must offer to sell oil—at vaguely specified prices—to countries with allocation rights.

Meanwhile, the U.S. government unilaterally began to fill the Strategic Petroleum Reserve (SPR), a large reservoir of oil stored in salt mines in Texas and Louisiana to be used if world supplies fall by an unspecified magnitude for an unspecified duration.

How should the U.S. government respond to a large drop in oil supplies caused by a revitalized OPEC or by internal strife in Mideast oil-producing countries? Should it keep its commitment to the IEA's oil-sharing agreement? Should it draw down its stocks of oil in the SPR, either unilaterally or in concert with other nations that hold stocks? Should it try to act like a buyers' cartel, and if so should it do so by imposing import quotas? These and other questions are addressed in *Responding to International Oil Crises*, a collection of essays edited by George Horwich, professor of economics at Purdue University's Krannert School of Management, and David Leo Weimer, professor and deputy director of the University of Rochester's Public Policy and Analysis Program.

In his comprehensive analysis of IEA policy, one contributor, Rodney T. Smith, shows that the IEA's Emergency Sharing System would either be ineffective or harmful. Smith points out that if world oil supplies were suddenly cut, the world price would rise until markets cleared. The higher price would bring forth additional supplies from oil wells and from stockpiles, and would cause oil users to reduce their consumption. In his argument Smith assumes that the Emergency Sharing System is activated after the market has already adjusted to the disruption in supply. This assumption is controversial, and is disputed in a chapter in this book by Richard N. Cooper, former undersecretary of state for economic affairs under President Carter.

However, if the sharing is triggered by a recorded 7 percent or greater drop in oil supplies, then Smith's assumption has to be correct, because in order to share oil, you have to know how much is available. That is, you need data on current supply. But although the *concept* of supply in economics is well understood, supply itself can not be directly measured. What can be measured is consumption, which (assuming no change in stocks) will equal supply. This means that to know current supply, you have to know current consumption. I conclude that the sharing agreement can be triggered only after each country has already adjusted its consumption.

Smith, who shares this conclusion, proceeds to calculate the gains and losses from the ESS. He points out—as do Horwich, Hank Jenkins-Smith, and Weimer—that buyers of oil in countries with allocation rights will not exercise these rights except at prices below the world price. Therefore, for the ESS to have any effect, it must give buyers the right to purchase oil at below-market prices. But this presents a problem. For the IEA to get such supplies, a member government with an allocation obligation would have to buy oil from its residents. Such a purchase would drive the domestic price above the world price. Domestic oil users in a country with an allocation obligation would then buy more oil at the lower world oil price. The only way to stop them would be to restrict imports. Similarly oil prices in countries with purchase rights would be below world levels, causing residents of those countries to sell oil to users in other countries. The only way to stop them would be with export controls. The net result is inefficiency, because oil would be prevented from going where it is valued more and would instead be used where it is valued less. For a 7 percent reduction in supply, Smith estimates the aggregate loss in efficiency for the IEA members to be about $1.1 billion annually.

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This estimate is surprisingly small. On the other hand, the estimate by Horwich, Jenkins-Smith, and Weimer—$116 billion—is surprisingly large. No attempt is made in the book to reconcile the two. The difference could be due to differences in the models. But then surely we should be skeptical about at least one of the models. Another possible reason for the difference is that in the model of Horwich, *et al.*, oil-sharing (mysteriously) increases consumption by IEA countries and drives up the world price. Yet the increase in consumption is slight—0.8 percent. Would this drive up the price enough to cause an extra $100-plus billion in losses?

Horwich, Jenkins-Smith, and Weimer, contrary to Smith, believe that the IEA could implement oil-sharing before the market has had time to adjust to an oil supply disruption. But the only way to do so, it would seem, is if the IEA bureaucrats are responding to an anticipated disruption, not to one that has already occurred. Otherwise, by the time the IEA gets together to implement oil-sharing, the world oil market already will have adjusted. How long after the Persian Gulf shutdown would oil traders in Tokyo be on their telex machines buying non-Persian Gulf oil? Not weeks, maybe not even days, but hours. That is what happened in 1979, when the Iranian revolution reduced production in Iran and temporarily reduced supplies to Japan. According to Department of Energy veterans, the Japanese government contacted the U.S. government for help in getting oil. The White House quickly held interagency meetings to discuss the situation. Forty-eight hours later, the White House contacted the Japanese, only to be told that there was no problem—the Japanese had already lined up alternate supplies.

Horwich, *et al.* do point out one potential offsetting benefit from the ESS. If each country's allowed consumption is treated only as an enforceable ceiling with no requirement that those with allocation rights exercise them—they call this "partial implementation"—then, they argue, IEA consumption will decline. The ESS will turn the IEA into a buyers' cartel and will drive the world price of oil down. The gains from cheaper oil, they find, can more than offset the loss from inefficient allocation of oil. The net result is a gain to the IEA members of about $21 billion per year.

Interestingly, Horwich, *et al.* do not then conclude that the ESS should be partially implemented. Indeed they show that if the IEA begins with partial implementation, then pressure on member governments by special interests could quickly lead to full implementation with all its associated losses. Therefore Horwich and Weimer advocate that the United States withdraw from the ESS.

A better policy than partial implementation of the ESS, they argue, would be a "disruption tariff," that is, a tariff imposed on oil by all the IEA members during an oil supply disruption. Such a tariff, if imposed by all IEA members, would have the salutary effect of forcing down the world price without causing inefficient allocation of oil among IEA countries.

Not all of the book's authors are as confident as Smith or as Horwich, Jenkins-Smith, and Weimer that the world oil market would function so well during a disruption without mandatory oil-sharing. Dissenting from their view are authors Daniel B. Badger, Jr., a former IEA employee, and Richard N. Cooper. Badger claims that if the government did not intervene to allocate oil during a supply disruption, shortages and lineups would be inevitable. Oil companies would be "unwilling to assume the responsibility" of raising prices to eliminate shortages.

The truth is precisely the opposite. Shortages and lineups are inevitable when the government intervenes to control prices below market-clearing levels. That is the main energy lesson of the 1970s. When governments refrain from imposing price controls—as did the West German and Swiss governments during the 1970s, for example—oil companies are quite willing to "assume the responsibility" of raising prices to make millions of dollars in added profits.

Cooper's case for the ESS is more sophisticated. He argues not that prices will fail to clear the market quickly, but that the spot market will clear at an artificially high level. Why? Because most oil, according to Cooper, is purchased at contract prices rather than at spot prices. These prices, he claims, are "sticky"; they do not increase quickly when supplies fall. This stickiness, Cooper argues, puts a disproportionate burden of adjustment on spot prices. Invoking the ESS would allow oil users to avoid buying on the spot market and bidding the price so high.

Close scrutiny reveals two flaws in Cooper's argument. First, as Horwich and Weimer point out in their concluding chapter, contract prices are quite flexible: virtually all contracts provide for price changes every three months. Also, they point out, on 30 days' notice, sellers may termi-

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nate contracts or offer discounts. Second, and more important, even if contract prices were sticky, buyers who paid these low prices could simply turn around and sell the oil on the spot market, thus preventing spot prices from rising unreasonably.

Should governments stockpile oil for use during an oil supply disruption, not just for their own uses, but also for their residents'? Rodney Smith points out that if governments are expected to refrain from imposing price controls during a supply disruption—admittedly a big if—the anticipated high price is a strong incentive for companies and individuals to hold oil reserves. Will they hold enough reserves? That depends, writes Smith, on two offsetting factors. On the one hand, when private storers sell off reserves during a disruption, they will benefit buyers by driving down the price. Because no individual storer will sell enough to have a perceptible effect on the price by himself, however, private storers will not take account of this beneficial effect (a positive externality) when storing oil in the first place. The result is an understocking of oil. On the other hand, notes Smith, neither will private stockpilers take account of the increased price (a negative externality) caused when they add to their stockpiles. The result is an overstocking of oil. On net, as Smith concludes, one cannot say whether private stockpilers who do not fear price controls will build too few or too many stocks.

Given that governments have built large stocks, should they coordinate their drawdowns? John Weyant believes they should. Coordination, writes Weyant, "may be required to ensure large aggregate drawdowns." If this is so, might it not be because some governments want to maintain their stocks on the expectation that the disruption will last long and keep prices high? Surely this expectation *could* be correct. If so, are governments wise to risk exhausting all their stocks? A safer policy than Weyant's seems to be to let each storer, private or government, act on his expectations.

The authors, who address the issue of import quotas, unanimously agree on the perversity of import quotas. A whole chapter, written by Horwich and Bradley Miller, is devoted to showing the great harm that can be inflicted on the country that imposes quotas. Unlike a tariff, an import quota can cause a supplier with some monopoly power to raise the world price of oil. How? Imagine that the United States currently imports seven million barrels of oil per day and announces that henceforth it will limit imports to six million. OPEC can help accomplish this by raising the price until only six million barrels per day are demanded. Horwich and Miller show that such a price increase will occur even when OPEC is not a perfectly functioning monopoly.

In the final analysis, though some of the authors disagree, *Responding to International Oil Crises* makes a strong case against IEA-mandated oil-sharing during a supply disruption. The book is an important addition to the stock of knowledge available to policy makers.

City to City

Deregulation and the Future of Intercity Passenger Travel, John R. Meyer and Clinton V. Oster, Jr. (MIT Press, 1987), 312 pp.

Reviewed by James Voytko

Like a rather disjointed movie sprinkled with excellent individual performances, *Deregulation and the Future of Intercity Passenger Travel* presents some good analysis and important conclusions for transportation policy makers combined in a frustrating structure. This structure is an easy target for criticism. Indeed, there are two small books here joined in the middle. The first is a lengthy and detailed recounting of the nation's experience with airline deregulation through 1985. The second, only loosely connected to the first and overshadowed by its length and level of detail, deals largely with competition between passenger modes—air carrier, bus, automobile, and rail—and the ways in which exogenous variables, such as income growth and public policy, influence the struggle for market share in intercity travel. Any transition between the two sections, from historical data on airlines to forecasts of multi-modal markets, is largely missing.

Within each "book within a book," however, there is much of value for the reader. The summary of the beneficial effects of airline deregulation will thoroughly impress all but the most closed-minded reader. The analysis of deregula-

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tion's positive effects on airline fares, productivity, and employment displays both clear objectivity and an impressive level of detail. It is the third in a series of reports generated by the Harvard Airline Deregulation Study begun in 1979.

The second "book," however, is the more intriguing of the two. Here the authors' conclusions are more relevant to regulatory policies now under discussion at the federal level. For instance, a common refrain during the annual debate over the Amtrak subsidies has been "Why can't the United States have fast, well-patronized passenger train service like Europe and Japan?" The authors argue quite convincingly that the well-utilized train systems in these countries result far more frequently from the regulatory *impediments* their governments place on competing modes than from some inherently better idea of how to provide passenger rail service. The message their analysis sends to policy makers seeking to "save" passenger rail service in the United States is straightforward: Be prepared to restrict the public's access to other transport modes (such as airplanes and automobiles) whose cost and service quality is determined by a largely deregulated market, *and* be prepared to continue the current level of rail passenger subsidies—a thoroughly unappetizing prescription, one would think.

The most disturbing aspect of this part of the book is the authors' enumeration of the "dangers" of deregulation. They believe that there is the potential for transport monopolies, for chronic financial instability in the transport industries, and for extreme differences in access to intercity transport by various segments of society that could threaten reliance on the market for intercity passenger transport. As they correctly note, however, there is little evidence that any of these possibilities pose real economic problems. A different sort of analysis—one focused more on the political economy of deregulation—would likely reveal that the "danger" is not so much that the market will fail, but that the public's concerns may provide entry points for reregulation and the reestablishment of the special interest benefits that accompany it.

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(Continued from page 29)

I admit that shareholder gains do not necessarily equal social gains. But to say takeovers are bad, we have to find a clear loser because we know someone is benefiting. The only possible losers are managers and employees. I have argued at great length elsewhere that the tin parachute is something the court should show great tolerance because with very generous programs of tin parachutes there need not be any clear losers.

PROF. ROMANO: Let me say two things in response. First, I do not think all firms can be profitably taken over, and not every CEO, when nearing retirement, can find someone who can profitably pay a lot more for the firm.

Second, we focus on enhancing shareholder value because when looking at a corporation, it is difficult to conceive of who else's interests would be appropriate for determining the efficient allocation of resources in the economy. For instance, the literature suggests that firms that are worker-owned rather than shareholder-owned, such as Yugoslavian firms, do not end up with the most efficient allocation of resources. Workers appear to have far shorter time horizons than investors. In fact, in the U.S. plywood industry, where we have workers' cooperatives, workers hire managers and these firms look a lot like corporations with outside non-management shareholders.

MR. GRUNDFEST: I agree with Mr. Butcher's observation that the modern role of the shareholder is very different from the 19th-century role of the owner in a closed corporation. Corporations raise capital from a variety of sources: by borrowing money, by selling preferred stock, or by selling common stock. These various sources of capital exercise different types of control over management.

Nobody says,"Here, have some money, have fun." Bond holders lend money and in return get covenants that protect them. Preferred shareholders have other protections. Common stockholders are most at the mercy of the decisions made by management. The board must vote to give them dividends. They are the ones with the residual claims that have value after everybody else has been paid off.

I think we are seeing a change in the technology of finance that has increased the power of the shareholder in corporate control. After many years of neglect, the shareholders are revolting against a system that has not rewarded their risk and investment as well as it could have.

Is the only role of the corporation to enhance shareholder value? Of course not. That would never work. To enhance shareholder value, you have to have satisfied workers and good products, and you have to make a profit. Nobody will invest in a corporation whose workers are on strike all the time or who do not produce quality products. I believe that in corporations in which management is doing a bad job, workers *and* stockholders are hurt.

Consider the automobile industry. Honda and other companies are building cars in the United States for export to Japan. The capital investment in those plants is a fraction of the investment that General Motors has made in many of its facilities over the last few years. Who has been hurt in General Motors? The workers and the stockholders. If you help the workers, you will help the stockholders. If you help the stockholders properly, you will definitely help the workers. It is a cooperative situation, not a competitive one.

I disagree with Jack Coffee about one thing: tin parachutes. Tin parachutes are hypocritical. A tin parachute says that if I, senior management, get fired or lose my job in a hostile takeover, you, middle management and lower level employees, will get tremendous severance benefits at the expense of the stockholders. However, if I keep my job but decide to restructure the corporation, you get nothing—and the stockholders lose nothing. It is a hostage strategy, pure and simple. I think those types of strategies will not, in the long run, serve management's interests. They will increase pressure at the federal level for job security legislation, for plant closing legislation, and for rules against laying people off under a wide variety of circumstances. The regulators' rationale will be that we are not doing anything that management was not willing to promise anyway.

PROF. COFFEE: In several airlines, the pilots' and machinists' unions are negotiating for a right of first refusal to take over the company. At United, the new collective bargaining agreement terminates in the event of a takeover. That is not purely a case of management putting in a poison pill. That is the union's own self-interested position. Faced with a new level of job insecurity, workers want the ability to renegotiate.

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If we see a potential for opportunism, we should be sympathetic to new contracting arrangements which try to reduce the prospect for opportunism, such as by giving some kind of takeover-related severance benefits. I think we will see more of this. Without legislation, and I am certainly not urging any, we will see new contracts involving employee unions, particularly in industries like the airlines.

MR. GRUNDFEST: I understand how you could say that these new contracts just reaffirm the preexisting arrangements. However, in some industries, wages are way out of line with the wage costs encountered by new entrants. Someone can hire a group of pilots at far less than they are being paid at their current airline jobs, lease a fleet of planes, and be in the airline business, competing at lower costs. This reflects a fundamental disequilibrium in the industry. To the extent this type of renegotiation takes place, putting contingent claims on an existing firm, losses are shifted from workers to the stockholders and other people with capital claims on the corporation. This increases the cost of capital in these industries. In this process, losses are never eliminated—they are merely shifted.

PROF. COFFEE: Are you suggesting that if the union and the existing management reach such an agreement, you would invalidate it?

MR. GRUNDFEST: Absolutely not. The point I am making is that these contracts will be unstable unless the participants also address the underlying economic changes that induce the renegotiation.

PROF. COFFEE: We have not seen stability in the takeover field since the very first takeover.

PROF. ROMANO: It is important not to forget the context in which the controversy over takeovers and the demand for their regulation arises. In our federal system of government, corporate law is under the jurisdiction of the states. We have dual jurisdiction of takeovers, however, through the Williams Act, which is part of the federal securities laws. The modern debate over who should regulate corporations, and hence corporate takeovers, was launched by William Cary's 1974 article on federalism and corporate law in the *Yale Law Journal*. Cary called for federal regulation to end what he termed "the race for the bottom": the competition between the states to loosen corporate regulation and thus to attract more corporations. Delaware was—and is—winning this competition.

The classic statement in support of regulation by states, which permits competition among regulations, was Ralph K. Winter's response to Cary. This was expanded into a book, *Government and the Corporation*, published by the American Enterprise Institute in 1978. Winter identified a crucial flaw in Cary's analysis. He suggested that the race was to the top, not to the bottom. Cary had overlooked the fact that firms operate in many markets, including the capital, product, and corporate-control markets. Each of these constrains managers from operating under a suboptimal legal regime for, as Winter argued, firms in non-value maximizing legal regimes will be outperformed by those operating under value maximizing laws. They will have lower stock prices, subjecting their managers to the possibility of replacement by a successful bidder who can increase firm value by changing domicile.

Managers have an incentive—job protection or preservation—to opt for the legal regime that shareholders prefer, the one that maximizes the value of the firm. Accordingly, states have an incentive to offer value maximizing laws: doing so increases revenues by attracting corporations from other states.

Since Cary's and Winter's papers were written, we have accumulated much empirical evidence on the effects of state competition. If state competition truly harms shareholders, we should expect the stock prices of firms that change their state of incorporation to drop. Yet using conventional financial econometric techniques, several studies have found the opposite: such firms had either statistically significant increases or no significant change in their stock prices. No study has found a negative stock price effect—that is, any shareholder wealth loss—from reincorporating.

Do states compete for incorporation business? As innovations in corporation codes spread across the states, there is evidence of a positive correlation between a state's responsiveness and the percentage of its revenues received from franchise taxes. My own research has sought to explain Delaware's continued success in the corporate charter market. As a measure of its success, consider these figures. In a sample of about 700 firms that changed their state of incorporation between 1961 and 1983, 82 percent moved

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to Delaware. Slightly more than half of *Fortune's* top 200 manufacturing firms are in Delaware.

Firms, particularly those that go to Delaware, relocate when they anticipate engaging in certain types of transactions, such as public offerings, mergers and acquisitions, or defensive tactics against takeovers. These transactions increase the likelihood of shareholder litigation. The cost of such transactions can be reduced under a new legal regime.

After a firm incorporates in a particular jurisdiction, the state can change or fail to update its code when other states innovate; relocating would be costly for the firm. This leaves firms vulnerable to opportunistic behavior by states.

To be able to charge a premium for chartering in its jurisdiction, a state must guarantee that it will not be opportunistic, that it will continue to respond to the firm's demands. Delaware receives a large proportion of revenues from the franchise tax: from 1960 to 1980, franchise taxes averaged about 16 percent of state revenues. This high percentage guarantees continued responsiveness because Delaware has no readily available alternative source of revenue. In addition, many of Delaware's citizens earn substantial income by servicing Delaware corporations. Other states, such as New York and California, collect more from the franchise tax in absolute dollar terms, but only about 1 percent or less of their budget.

Managers have an incentive—job protection or preservation—to opt for the legal regime that shareholders prefer, the one that maximizes the value of the firm.

Delaware also has invested in intangible assets that have no use outside the chartering business. These assets, loosely called "legal capital," are a stock of legal precedents and judicial and administrative expertise in corporate law. This legal capital commits Delaware to being responsive. Delaware also has a first-mover advantage, making it difficult for another state to compete successfully by, for instance, offering the same code as Delaware but at a lower tax rate.

Admittedly, state takeover laws are the laws that are most troubling to proponents, like myself, of a state system. The reason is that changes in control are often accompanied by changes in management personnel, resulting in a very strong potential for conflict of interest between managers and shareholders over the success of a bid. Even here, though, I think the cautiousness of Delaware's approach provides some encouraging support for state competition. The extensive deliberative process in Delaware produced a law that is less restrictive of bidders than the laws of other states.

The problem is highlighted by the legislative process of takeover laws, which leaves much to be desired. State takeover laws are typically promoted by the Chamber of Commerce at the behest of a major local corporation that is, or fears it will be, the target of a hostile bid. The urgency of the firm's situation leads to rapid, sometimes overnight, enactment of legislation with little or no public debate. In fact, this is one feature that differentiates Delaware from other states. Delaware has such a large and diverse corporate constituency, including bidders as well as targets, that no one firm's management has the clout to get a bill passed overnight.

I think a damning feature of the recent state legislation is that it codifies defensive strategies that firms could already have adopted voluntarily by charter amendment. The difference between "self-help" and the legislation is that self-help requires a shareholder vote of approval; the vast majority of state takeover laws, on the other hand, cover firms unless they opt out, allowing managers to avoid obtaining their shareholders' consent.

The way these laws are enacted leaves me with a nagging suspicion that the managers promoting them believe that their shareholders' approval would be harder to obtain than their legislators'. There may be good cause for such a concern. The available empirical evidence on the effects of state takeover laws does not promote confidence in their value maximizing qualities. Studies find that these laws have either a negative stock price effect or an insignificant effect on share prices of firms incorporated in those states. If state takeover laws really increase shareholder welfare, we would expect to see a positive return to the affected firms. As in the case of reincorporations, although the data are not conclusive, they are relatively one-sided.

If there is an area of state regulation to worry about, therefore, it is takeovers. This does not mean that preemption by federal regulation is the answer. Most of the bills introduced in Congress rival the proposals before state legisla-

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tures in attempting to restrict bids. There are some differences in the constituencies at the national level and those at the state level: the former include the SEC, the securities industry, and some organized groups of investors. But it does not strike me that laws emanating from the U.S. Congress would necessarily be much different, let alone better.

So while our positions on the efficacy of takeovers probably differ greatly, I agree with Murray Weidenbaum that the best way to deal with corporate activities is through the parties' private contractual arrangements. If shareholders of a firm want to restrict their firm's ability to receive a bid, that is fine. They should place those restrictions in their charters. I am leery of the economic consequences of increased intervention in corporate governance.

With federal regulation, we lose the edge of responsiveness to changing circumstances, the key element in an efficient system of state competition.

But if we have to have government regulation, state regulation is preferable to federal regulation. With federal regulation, we lose the edge of responsiveness to changing circumstances, the key element in an efficient system of state competition. Given the size of its budget, the federal government has no revenue incentive to meet firms' desires. And corporate law, which deals with the relationships between shareholders and managers, is hardly a salient election issue at the national level. It is hard to believe that an unresponsive member of Congress would suffer immediate adverse reelection consequences; a Delaware legislator who suddenly shifted his or her position on corporate law would.

Most members of the public, as consumers and workers, stand to gain from a strong takeover process and from the efficient allocation of resources that occurs when firms are being run in the shareholders' interests. Yet the sentiment expressed in public opinion polls is negative toward mergers and takeovers. Maybe the poll results are misleading. We all know the importance of framing survey questions for the responses that are elicited. But as long as this mistaken view prevails, federal legislators would be under strong pressure to support the demands of the intensely vocal managers, the beneficiaries of the regulation, over the interest of the diffuse population of shareholders. This serious problem of public misperception must be recognized and addressed before anyone can optimistically embrace federal preemption of state takeover laws.

MR. GRUNDFEST: The takeover battle has traditionally been fought in Washington, DC, before the House and Senate committees that have direct oversight over the securities laws, and before the SEC. Within the last month, this has changed dramatically. The battle is about to be fought in Wilmington, Delaware, not Washington, DC.

The move from Washington to Wilmington was precipitated by a decision of the United States Supreme Court in the CTS case, which, to the surprise of many observers, upheld an anti-takeover statute adopted by the State of Indiana (*CTS Corporation* v. *Dynamics Corporation of America,* 107 S.Ct. 1637, 1987). This statute required referendum approval from fellow stockholders before anyone who sought to acquire stock beyond certain thresholds could exercise the accompanying voting rights.

This decision breathed new life into the state anti-takeover movement. Since the CTS decision, approximately 15 states have adopted anti-takeover statutes of various forms. The latest, and by far the most significant, proposal is under consideration in Delaware. Under Delaware's proposed statute, if you are involved in a hostile takeover and do not acquire 90 percent of the target corporation's shares, then you cannot engage in certain self-dealing transactions for three years. Among other things, you cannot merge the acquired corporation into any other corporation in which you have a sufficiently large interest, and you cannot sell the assets to a corporation that is one of your affiliates.

A very significant debate is brewing as to whether this will really limit takeover activity, or whether the statute has so many loopholes that takeover lawyers and investment bankers would need only about a week to figure out a way around it. I do not know the answer.

MR. DeMUTH: How does the panel see the state takeover legislation playing out?

PROF. COFFEE: The Delaware statute will cause only a mild chill. Even before that law, the

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"Bandits at two o'clock, Mr. Feldon!"

Drawing by M. Stevens; © 1988 The New Yorker Magazine, Inc.

bidder typically wanted to acquire 80 percent of the target for tax reasons: at that level or above, intracorporate dividends are tax exempt. If the bidder acquires 85 percent, the new Delaware statute is inapplicable. Even when it applies, all the bidder is prohibited from doing is selling the assets to himself, merging with himself, or lending to himself. But he can sell the company in one piece to a third party or auction off a hundred pieces to a hundred different parties, and pay out the proceeds as dividends on a pro rata basis. And the bidder can keep on buying stock up to the 100 percent level. Once the buyer takes control and buys more stock, he will eventually cause a delisting of the company. Once the company is delisted and illiquid, the shareholders will sell to him because there is no other gain: he may even have suspended earlier dividends. There is a coercion potential there at least.

The Delaware law will also change the strategy for executing takeovers. We will see more 100 percent bids and fewer partial ones. We will see many bids conditioned on getting 85 percent control because then the statute does not apply.

So the short answer is that all that really counts for most of the New York Stock Exchange companies is Delaware, and I think Delaware has taken a deliberately cosmetic position. The statute does something, but not much.

MR. GRUNDFEST: I disagree with Jack Coffee about the likely consequences of the Delaware statute.

If raiders use those tactics, they will generally be perceived as squeeze-out tactics—very unfair and heavy-handed. The next generation of legislation could easily close those loopholes. To use the loopholes could be to doom them.

EDITORS' NOTE: *Delaware adopted its anti-takeover statute in February 1988. In accord with certain suggestions made by Commissioner Grundfest, the statute was amended to provide for an exemption for any bidder who obtained 85 percent of a target's shares, excluding shares held by the target's management or controlled by certain pension plans that vote shares at management's direction.* □

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(Continued from page 3)

fications work to keep the costs higher than would be the case under an alternative cellular plan.

The same inability to sort out and choose among technical options that have the greatest potential for serving market structure goals almost certainly will render ineffective the article's suggestions for how to allow the BOCs back into services now proscribed. Noll suggests that a BOC should be allowed to enter now-forbidden markets if it can show that the service it proposes is unlike any offered by other firms; if there are significant economies in offering an integrated service; and if anticompetitive strategies are technically infeasible or easily detected. The debate over voice storage and forwarding that led to the repeal of the separate subsidiary requirements for the BOCs is a sobering reminder of how effectively BOCs can use the inability of regulators to make sound policy judgments in the face of competing technical claims. The separate subsidiary requirements initially were imposed to make anticompetitive behavior either infeasible or easily detected. BOC claims that those requirements had prevented the public from receiving a technologically new and highly beneficial service caused their repeal. This occurred, moreover, despite serious argument that the service was not offered because there was no demand for it. Regulators will not be in a better position in the future than they are today to discriminate between valid assertions about the novelty or benefits from technological developments, or about the needs for waivers of any policies designed to thwart anticompetitive behavior as a precondition for enjoying those developments.

Only if the twisted pair is "untwisted," as the article urges, will competitive forces—and the heightened technological change that those forces encourage—continue to improve the telecommunications offerings available in the United States. The article is also right to call attention to the institutional problems that block the possible emergence of competitive technologies. Unfortunately the institutional forces opposing the steps that are necessary to untwist the pair are much stronger than the article reveals. Unless those forces can be countered, the outcome is almost certain to be a return to the past of regulated monopoly, with all of its inefficiencies.

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NOLL responds:

The two letters focus on the most problematic and controversial element of my article: that competition in local exchange services will not be made infeasible by future technological developments. David Reed points out that this rosy view of future technical developments may be unnecessary, for if natural monopoly is present, it is likely to be confined to the conduits connecting customers to the local central office switch. If open network architecture becomes a reality, others can enter to compete with local telephone companies for all switched and information services. If it does not work, Reed's proposal seems to lead to a truly Draconian line-of-business restriction: BOCs get to own the conduit connecting customers to the central office switch, but nothing more! In either case, two conforming regulatory moves are required: unbundling local access charges to separate local loops from central office switches, and permitting entry into literally everything provided by local telephone companies (except the local loop).

The logic of Nina Cornell's argument is a bucket of cold water on David Reed's proposal. She correctly points out that local telephone companies possess important informational advantages in regulatory proceedings, and hypothesizes that the differences between state and federal regulatory policies arise in part for this reason. Both federal and state regulators are prone to give too much to the BOCs in terms of restrictions against competition and relaxation of line-of-business restrictions because they are unduly impressed by the BOCs' promises regarding new technologies.

There is much to recommend this hypothesis. Administrative procedures do advantage participants who possess superior information. And the history of federal regulation of AT&T provides some good examples to support Cornell's pessimistic prediction. For example, AT&T succeeded in convincing the Federal Communications Commission that "foreign attachments" (that is, customer equipment not manufactured and owned by AT&T) threatened the "systemic integrity" of the national telecommunications network, a claim subsequently disputed by the company's own engineers.

Nonetheless, I am not as pessimistic. First, AT&T lost, despite its far superior technical knowledge. In the 1990s and beyond, failing a backslide into regulated monopoly, AT&T will have to test the validity of its technological visions in the marketplace—where such tests belong—rather than before judges and regulators. Second, the BOCs do not possess the informational advantage that AT&T enjoyed prior to the 1970s. Indeed, AT&T is poised to fight vigorously the reintegration of the BOCs, and despite dire predivestiture predictions, Bell Labs remains a formidable repository of technological sophistication. Third, if the BOCs win in the short run on largely specious technological grounds and, as a result, invest in a range of economically unwarranted technologies, regulators eventually will notice as the companies ask for ever-higher basic exchange prices. It is reasonable to expect that this will cause a backlash, just as AT&T's ventures into random orbit satellites, picture phones, and foreign attachment interfaces caused a backlash two decades ago. Fourth, the BOCs themselves may tire of regulated monopoly, and use their technological advantages to encourage competition for the purpose of escaping the yoke of regulation. For this to occur, of course, regulators must give them the incentive to behave in this way. The point of my proposal, linking relaxation of line-of-business restrictions to procompetitive actions by BOCs and state regulators, is to create these incentives.

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